Tariff Q&A

Tariffs are usually intended to protect domestic producers by placing a tax on imports, thus raising their price and reducing import demand. In effect, tariffs impose a higher cost basis on the domestic economy relative to the rest of the world. In addition to an immediate impact on prices, longer-term harms include economic distortions and slower growth. The following Q&A addresses selected issues raised by tariffs.

Who bears the costs of tariffs?

It depends. There are three main factors to consider. First, to the extent that tariffs are passed on to the ultimate consumerrather than being absorbed by the producer, purchasers of imports will face higher costs. (Empirical studies of the impact of the 2017-19 tariffs find that all of the direct costs of the tariffs were passed through to consumers.) In addition to these direct costs to buyers of imports, society as a whole faces the cost of reduced efficiency. These costs are offset by the fiscal revenue generated by the tariff and the higher prices domestic producers can charge for their products now that they now face reduced competition from imports. Moreover, increased tariffs are often met with retaliatory tariffs by trading partners, as they were in 2017-19, to the detriment of domestic exporters and the global trading system.

Are tariffs inflationary?

Yes. The immediate impact of a tariff is to increase the price level. Estimates of the 2017-19 tariffs suggest that the average household faced increased annual costs of $625. In addition to increasing the costs of imported goods and thus the domestic price level, tariffs also shift consumption to more costly or lower quality domestic producers, in effect subsidizing less efficient producers at the expense of consumers. In this way, tariffs limit the variety of goods available to consumers, imposing intangible costs and reducing welfare.

Would tariffs make the U.S. economy more competitive?

No. On the contrary, to the extent that the goods subject to tariffs are inputs in production, a tariff on imports would raise the cost of producing goods in the U.S. Foreign firms, in contrast, would not be faced with these higher input prices and would thus compete more effectively against U.S. firms in international markets. In the case of countries with highly integrated supply chains – like Canada, Mexico, and the U.S. –where intermediate inputs cross borders multiple times in the production process, the disruption created by tariffs would be far greater. The appreciation of the exchange rate that typically accompanies a tariff increase would further erode export competitiveness. Empirical studies of the 2017-19 tariffs found that export competitiveness and volumes declined.

Why do tariffs result in exchange rate appreciation?

By reducing imports, tariffs reduce the supply of U.S. dollars available in the foreign exchange market while also reducing U.S. demand for foreign currencies. To the extent that tariffs are inflationary, the prospect of higher interest rates may also attract capital flows in anticipation of higher yields, further increasing dollar demand.

Could tariffs close the current account deficit?

Not on their own and not without a painful adjustment. It is beguiling to suppose that tariffs could close the chronic U.S. external current account deficit by compelling consumers to replace imported goods with those produced domestically. While this is, at a stretch, conceivable for an individual, it is not feasible in aggregate. To close its current account deficit, the U.S. would have to limit aggregate demand to domestically produced goods. Doing so would require a significant contraction of aggregate demand – a process that would likely entail a painful recession. So long as the U.S. consumes more than it produces, the shortfall will be made up with imports.

Could the External Revenue Service replace the IRS?

No. The tax base of tariffs is too narrow. Goods imported into the U.S. in 2023 amounted to 11% of GDP relative to total tax revenue of 16.5% of GDP. Fiscal revenue in 2023 included customs duties amounting to 0.3% of GDP, or 2% of total receipts. Given these orders of magnitude, no level of tariffs could realistically be expected to replace all fiscal receipts.Moreover, replacing progressive income taxes (49% of total revenue) with regressive and distortionary tariffs would raise broader social and economic considerations.

How big were the 2017-19 tariffs?

In 2018-19, the U.S. imposed tariffs on 17.6% of 2017 imports, representing about 2.6% of GDP. The average tariff rate increase was 22.1%. These tariffs cost buyers of imports the equivalent of about 0.6% of GDP in 2018. Retaliatory tariffs were imposed on U.S. exports amounting to 1% of GDP, bringing the total amount of U.S. trade subject to new tariffs to 3.6% of GDP. Taken together, these measures increased the price of U.S. manufactures by about 1 percentage point. The long run drag of these measures are estimated to shave 0.2 percent off GDP growth.

Are tariffs good for anything?

Yes. Threats of tariffs made to extract concessions from trading partners who directly or indirectly subsidize exports can be a valuable negotiating ploy. If and when tariffs are actually imposed, their main objective is typically to protect domestic producers from the low prices of imported goods. There may be sound reasons for doing so. The protected industry may be deemed essential for national security (steel, shipbuilding), central to maintaining a way of life (agricultural products), or the economy of important regions of the country (manufacturing). In these instances, a case can be made that the costs and distortions of tariffs are a price worth paying to achieve a social objective. However, as with all economic policies, tariffs entail tradeoffs and unintended consequences.

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