COMMERCE & TRADE

Assessing Trump's New Tariff Ideas

The former president still suffers from "Trade Derangement Syndrome."

BY PIERRE LEMIEUX

This past summer, Republican presidential nominee and ex-president Donald Trump floated the idea of replacing the federal personal income tax with import tariffs. The idea has since been memory-holed; somebody must have told him it was utterly impossible.

Current revenues from import tariffs represent 1.6 percent of federal revenues, while the individual income tax comprises 49 percent. A first calculation suggests that tariff revenues, currently at $72 billion, would have to increase some 2,900 percent to cover the lost income tax revenue. However, a commensurate tariff rate increase would not produce an equivalent effect on revenues because of the Laffer effect of any tax: As tariffs increase, the volume of imports decreases, eventually pushing down their total value and the resulting tax revenue. Because of the Laffer effect, economists Kimberly Clausing and Maurice Obstfeld estimate that tariff revenues are probably capped at $780 billion (Clausing and Obstfeld 2024).

That is about one third of current personal income tax revenue. If Trump were to eliminate that tax, he would need to cut 23 percent of federal expenditures to maintain a constant budget deficit. (Recall that, last year, total federal spending was $6.1 trillion on revenues of $4.4 trillion.) A major reduction of federal spending is certainly desirable and will soon become unavoidable without major tax hikes or an unsustainable increase in the public debt. But a sudden one-fourth cut in federal expenditures would not be realistic, especially for a president who, in his previous term, increased expenditures by more than half a trillion dollars *before* the pandemic (plus another $2 trillion increase in 2020).

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If a second Trump administration did try to increase tariffs with a view to replacing the revenues from the personal income tax, a huge shock would hit the federal budget and the American economy. Foreign retaliation and discontent would largely isolate Americans from the rest of the world. Hence the memory-holing of the idea.

TRUMP'S OTHER (LATEST?) PROPOSALS

Although less unrealistic, two other tariff proposals that Trump continues to entertain would also carry huge detrimental effects.

First, he has said that he would increase the tariffs on all goods imported from China to 60 percent (at least). Until last May, tariffs on Chinese imports ranged from 15 to 25 percent and hit two-thirds of the goods imported from that country. According to a study by the International Monetary Fund, the average American tariff rate on Chinese goods increased from 3 percent to 21 percent between 2018 and 2020. In May, President Joe Biden—an eager proponent of tariffs himself—announced additional ones ranging from 25 to 100 percent, but on only a small proportion (4 percent) of imports from China. Trump's 60 percent proposal would represent a near tripling of current tariffs on Chinese goods.

Second, Trump indicated he would add a 10 percent across-the-board tariff on imports from *all* other countries. To provide some comparison, the weighted average of US tariffs levied on imported goods (including China) is 2.3 percent. The new across-the-board tariff would thus represent a major shock.

Clausing and Obstfeld note these two tariff proposals would affect nearly 10 times the trade targeted by Trump's 2018–2019 China trade war. This would supercharge the attack on world trade that he initiated and Biden has continued. In a study for the Peterson Institute for International Economics, Clausing and Mary Lovely note, "These actions would violate US commitments to both free trade agreement (FTA) partners and the World Trade Organization (WTO)" (Clausing and Lovely 2024).

Trump claims the tariffs would boost the economy and working-class families. In fact, they would hit hard the American economy and lower-income families.

How tariffs work / A tariff is a tax on imported goods that is charged to importers and typically transferred or "passed through" to domestic consumers. Clausing and Lovely point out that "study after study has shown that US tariffs levied since 2017 have … been

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fully 'passed through' to American buyers." Buyers include both domestic consumers for final goods and domestic producers for intermediate goods. About 45 percent of imported goods in the United States are inputs for goods produced here, both for domestic consumption and for export.

Trump has denied that a tariff on foreign goods is a tax on domestic consumers. But he sometimes seems to not believe this. On August 13, 2019, while president, he announced that he would delay enforcing a new tariff on China until after the Christmas buying season to give American consumers a break. He declared:

> We're doing this for the Christmas season. Just in case some of the tariffs would have an impact on U.S. customers. So far, they've had virtually none. But just in case they might have an impact on people, what we've done is we've delayed it, so that they won't be relevant to the Christmas shopping season.

To better understand the full extent of a tariff's cost, we need to realize that it leads competing US producers to raise their own prices. As the quantity demanded for the domestic product increases, its price is bid up by consumers until the domestic price reaches the taxed price of the foreign good. Imports will have decreased, domestic production increased, and domestic purchasers will be paying the same price for both the imported good and its domestically produced equivalent—for example, two cars of the same brand or quality produced in Germany and in the United States. This is what "protection" means: Domestic producers are protected from the lower prices of foreign competitors; the tariff is a discriminatory tax that allows them—and even pushes them—to increase their own prices to the level of the now-tariffed imported goods.

Similarly, a tariff on an input (say, steel) is paid by the American importer who will typically pass it down the supply chain to his customers and eventually to the consumers of the final good (say, a car). After Trump imposed a special tariff of 25 percent on imported steel in 2018, for example, the chief executive of Byer Steel, a Cincinnati steelmaker, explained in a *Wall Street Journal* article (Simon 2018) how the tariff had led his firm to increase production and raise its prices:

> Demand came on so fast that we had to raise our prices or we would not have had one pound of steel for anybody. We raised prices to the point where the market said it is enough.

The article also featured an American business that was harmed by the tariff: Laclede Chain Manufacturing of Missouri, which laid off workers and cut overtime because of the higher input cost.

COST ESTIMATES AND OTHER RISKS

Economists have tried to forecast the economic costs of this pair of new Trump tariff proposals. Clausing and Lovely estimate they would impose on American consumers a combined cost equivalent to "at least" 1.8 percent of gross domestic product. This would amount to nearly five times the comparative cost of the 2018–2019 tariffs. Another estimate, produced by Erica York using the Tax Foundation's general equilibrium model, is a 0.8 percent reduction of GDP. The two estimates suggest a cost on the order of 1–2 percent in terms of lost GDP, which is still conservative when we realize that they admittedly ignore many further likely consequences of the tariff shock, too uncertain to be quantified.

One such consequence is the retaliation and trade war (or other international conflicts) that would likely follow. Indeed, the government of the European Union has been working on a list of American products to hit with retaliatory tariffs of 50 percent or more if Trump is elected and goes ahead with his 10 percent across-the-board tariff.

Like other economists, I have previously argued that retaliation by a national state—hitting some of its own consumers with tariffs in the hope of helping some of its producers preserve a foreign market—is a bad strategy (Lemieux 2014a, Lemieux 2018). If your neighbors' government dumps rocks in their country's harbors to block imports, you gain nothing if your own government retaliates by dumping rocks in your country's harbors. Yet, governments still use this absurd strategy because they respond more to the concentrated interests of well-organized producers than to the dispersed and disorganized interests of more numerous consumers.

Another effect of the tariff shock could be on future economic growth. The 1–2 percent cost represents a constant proportion of GDP as time passes (if the tariffs are not repealed), assuming the rate of economic growth remains the same after the first shock has been absorbed. Besides long-term growth, nobody can evaluate the probability that a large tariff shock would not cause a recession, stagflation, or even a depression. The Smoot–Hawley tariffs of 1930 are widely believed to have worsened what came to be known as the Great Depression.

A reduction in GDP of 1 percent is not insignificant. In 2023, it corresponded to $274 billion, or the cost of building some 550,000 single-family homes. Without the GDP loss, of course, the corresponding resources would be allocated by the market to whatever consumers want, be it homes, education, healthcare, vehicles, etc. A tariff increase causes a loss of production because more resources must be devoted to producing the goods previously imported at a cheaper cost, and fewer of some other goods can be produced. A concurrent factor is that the lack of foreign competition reduces competition and productivity in the domestic economy.

Income reductions / A 1 percent reduction of GDP translates into a lower annual income of about $2,000 per household. Of course, that loss would be borne unevenly across the population. So, who is more likely to bear it?

Clausing and Lovely show that the new tariffs would fall more on the people at the bottom of the income distribution because they spend a higher proportion of their incomes on consumption goods as opposed to savings and investments. The estimated 1.8 percent loss in GDP value would cost consumers in the highest quintile of the income distribution 0.9 percent of their after-tax income. This proportion increases as we move down the distribution from the highest quintile to the lowest. In the middle quintile, which we may consider the middle class, the loss would represent 2.7 percent of after-tax income. Consumers in the lowest quintile would suffer a loss of 4.2 percent. It is thus likely that those whom Trump claims to be helping would be the most harmed by the new tariffs.

Of course, nothing in the laws of the universe says that taxes need to be progressive, and much needs to be reviewed in the conventional interpretation of inequality and its measurement (Lemieux 2023). But we have here a clear case of a coercive state intervention—a prohibition of importing goods without paying a special tax—that discriminates against poorer people.

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MANY COSTS, LITTLE BENEFIT

The effect of the proposed tariffs on federal revenues would be very small. Clausing and Lovely use a conservative "semi-elasticity" of imports of –1, which means that a 10 percent increase in tariffs would reduce the volume of imports by 10 percent. (Semi-elasticity incorporates the behavioral responses along the domestic demand and supply curves.) If these proposed tariffs were already in place, the resulting increase in tariff revenues would have been $227 billion in 2023, roughly quadrupling their current level. But the increase corresponds to only 5.1 percent of total federal revenues. Over the 2026–2035 decade, considering the projected trajectories of trade with China and the rest of the world, the federal receipts from these tariffs would increase by $2.75 trillion—which sounds like a lot until you remember that it is over the course of a decade. In fact, the added revenue would not even cover the estimated $5 trillion budget cost of extending the 2017 Tax Cuts and Jobs Act, which Trump has promised.

A protectionism-sparked slowdown in economic growth would, of course, affect future incomes and consumption levels. It would also reduce future imports and thus the relatively meager federal receipts from the proposed tariffs.

Trade deficit / With these tariffs, American imports would decrease, but so would exports. The reduction of American imports would mean fewer US dollars would go overseas, increasing the dollar's value on foreign exchange markets. That, in turn, would make US exports more expensive for foreign buyers, pushing down their quantity demanded of US goods. Consequently, the trade deficit, an obsession of Trump's, would not necessarily decline despite the reduction in imports. In fact, it increased during his 2017–2020 presidency. Of course, the trade deficit has no economic significance by itself, but Trump's obsessive goal of reducing it would not be served by his new tariffs.

Government intervention begets government intervention. If Trump were to initiate a new tariff shock, special interest groups would vie for exemptions. Trade regulations would get more complicated and the "deep state" busier. A new fauna of lobbyists, lawyers, and bureaucrats would descend upon Washington. Americans would grow more accustomed to begging government for permissions. Smuggling would thrive, requiring still more regulation, surveillance, and enforcement. Other special interests would request subsidies and privileges to compensate for higher production costs or the closure of foreign markets. Again, we got a taste of this before, notably in agriculture: Calculations from the Council on Foreign Relations suggest the relief the Trump administration paid to farmers harmed by his trade war (and the pandemic) was equivalent to 92 percent of the federal government's total tariff revenues (Steil and Della Rocca 2020).

False problems / With so many real problems caused by tariffs, we should not imagine false ones. For example, we should not claim that tariffs would amp up inflation. If a tariff increases the price of one good, ceteris paribus, it means that less of the now-pricier good would be demanded, in favor of more of other goods whose relative prices will have fallen. It is true that the sort of widespread tariffs envisioned by Trump would shift the whole economy's production possibility frontier inward, where GDP is located. Like for any major supply shock, a one-shot increase in the value of money would follow; the same amount of money chasing fewer goods entails an increase in the general level of prices. But this would not generate what we usually call inflation, which is a sustained increase in the general price level—except if the Fed sustains it to forestall a feared recession. If the Fed does not create more money, the temporary "inflation" would stop there.

Econometric studies typically show an ambiguous employment effect from tariffs. This is not surprising. The volume of employment varies directly with the number of working-age people. What tariffs do is shift labor (and capital) away from the production of goods and services wanted by domestic and foreign customers, toward the protected industries of favored special interest groups. After a transitional period following a tariff shock, the same number of people will be working, but in less productive and thus remunerative employment.

THE CENTRALITY OF TRADE

Trump's tariff proposals may change again before the election or, if he is elected, after. His impulsive animus against international trade—call it "Trade Derangement Syndrome"—and lack of economic understanding don't augur well for what he would do in a second term. His running mate and political heir apparent, Sen. J.D. Vance (R–OH), might not have misspoken when, in an interview with CBS, he flatly declared, "We need to protect American industries from all the competition." The snowflake businesses need a safe space, I guess.

International trade is important not because it has a large accounting footprint in the American economy. Factoring in the domestic content in the price of imported goods and the foreign inputs in domestically produced goods, researchers at the Federal Reserve Board of San Francisco found that not more than 11 percent of personal consumption expenditures is imported (Hale et al. 2019). Recall that two-thirds of what Americans consume is comprised of services such as education, healthcare, and housing, of which only a very small part is imported. International trade is important because trade—internal and international—is central to economic efficiency.

International trade is nothing but exchange across national borders by individuals and their middlemen. This fact is often obfuscated by ways of speaking such as "the United States imports from Europe." In fact, "the United States" does not import or export; its people do. Trade within and across political borders has been a distinguishing and enriching factor in the human condition (Lemieux 2014b). Adam Smith famously emphasized "a certain propensity in human nature ... to truck, barter, and exchange one thing for another." This quality, he added, "is common to all men, and to be found in no other race of animals which seem to know neither this nor any other species of contracts."

Since Smith, economists have further developed the idea that the freedom to trade, an aspect of freedom of contract, is essential to economic efficiency. We can loosely define economic efficiency as the possibility for any individual to attain the best situation he can without coercively worsening the situation of others. Because a voluntary exchange must benefit all its parties (otherwise one would have declined), economic efficiency means that all exchange opportunities have been realized. This is ultimately the reason why a tax on sales or purchases creates a "deadweight loss," which represents opportunities of mutually beneficial exchange that the tax-increased price now precludes. Tariffs—that is, taxes on international trade—create *more* deadweight loss (are more economically inefficient) than internal indirect taxes because, being discriminatory, they "cause an inefficient reallocation of production" (to quote Clausing and Lovely). We may say that protectionist tariffs represent the paradigmatic case of an attack on economic freedom and prosperity.

Trump has floated other tariff ideas besides those reviewed in this article. For example, he threatened to impose a 100 percent tariff on *all* imported cars. Imagine Americans being obliged to pay twice the price for their cars! One wonders what other protectionist ideas he may dream up.

The sorts of tariff proposal that he has been airing for a second term would harm most Americans and especially the ordinary workers he claims to defend. Such proposals demonstrate a disturbing ignorance of basic economics and the meaning of economic freedom. *R*

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