Institute For Policy Innovation
IPI Ideas
Innovative Insights on Today's Policy Debates

NO. 76 March 2018

Five Undeniable Truths About Tariffs

by Merrill Matthews, Ph.D.

President Donald Trump has raised tariffs on steel and aluminum by 25 percent and 10 percent, respectively, and he appears to be itching to raise or impose even more tariffs.

Since the disastrous passage of the Smoot-Hawley Tariff Act of 1930, in which Congress imposed high tariffs on goods across the board, most economists and policy experts have discouraged tariffs and import restrictions. In fact, most support lowering tariffs both at home and abroad, seeing the economic benefits of free trade as outweighing any that might accrue to a limited number of protected companies.

But the Trump administration has failed to learn, or is simply disregarding, the lessons of the past and wants to make tariffs great again. What are some of those lessons?

A Tariff Is a Tax

A tariff is a tax the government imposes on its own citizens.

Tariff defenders imply a tariff punishes the exporting country. In fact, people living in the exporting country don't pay the tax; people living in the importing country do when they buy the tariffed products. Vendors in the exporting country may see their sales decline because of a tariff, but the importing country's consumers are the ones really punished.

But, defenders argue, the purpose of the tariff is to encourage domestic consumers to buy domestically made products and services. If they do, they won't pay the tax. Not necessarily.

If U.S. consumers refuse to buy the imported product, they may not pay the tax directly, but they may still pay it indirectly because companies protected from foreign competition usually raise their prices significantly.

For example, in 2015 the Obama administration imposed tariffs on steel imported from China. *The Wall Street Journal* reported two years later, "Domestic steel companies have raised prices by as much as 50% on popular types of steel in recent months. That has boosted their profits, but troubled customers who say they can't afford the higher cost."

More recently the *Journal* claims, "Since Mr. Trump took office, the price for American hot-rolled steel coil has increased by more than 35%, rising about $222 a ton, according to price data from S&P Global Platts. When the President signed orders imposing the tariffs on March 8, prices increased by more than 4% in a day."

However, purchasers can only avoid paying the tariffs if there are domestically made alternatives available. But there may not be and, depending on the product, it may take years for newly protected companies to ramp up production to meet the demand from domestic purchasers. In the meantime, companies needing the protected product have little choice but to purchase the highly taxed foreign imports.

Of course, domestic consumers may also continue buying the imported goods anyway, even if they have to pay more. That's because the imported item may be of higher quality, highlighting another unfortunate practice: Domestic manufacturers sometimes demand tariffs simply to protect themselves from better-made, as opposed to cheaper, foreign products.

A Tariff Is Inflationary

Inflation occurs when there is a general increase in prices without a corresponding increase in quality or quantity.

Take political efforts to raise the minimum wage to $15.00 per hour. There would be no corresponding increase in worker productivity—though defenders implausibly argue that better-paid, low-skilled workers would likely be more productive. Employers would just be forced to pay higher wages for the same level of productivity. That's inflationary.

It's the same with tariffs. The companies that use raw steel or aluminum to produce their own products—e.g., cars and aluminum cans—will have to pay more for the same product. That too is inflationary.

A Tariff Is a Government-Imposed Price Control

If there is one thing most market-oriented economists and policy experts agree on, it's price controls are bad economic policy, which is why they widely opposed President Obama's minimum wage increase proposals. That's simply the government telling employers how much they must pay for labor—i.e., price controls.

Well, a tariff is not only a tax, it's a government-imposed price control. It's the government deciding what the price of an imported product "should" be. Thus, anyone who opposes minimum wage increases should, in principle, oppose tariffs.

A Tariff Is Crony Capitalism

As a presidential candidate Donald Trump repeatedly promised to "drain the swamp" in Washington. One example of the swamp is when big-moneyed, special interests buy political access and favors to help their bottom line.

That's often how tariffs gain traction.

Company or industry executives and lobbyists who can't, or don't want to, compete against their rivals head to Washington to complain that other companies, or countries, aren't playing fair. The goal is to use the power of government to limit or punish their competitors—and to garner higher profits for themselves.

To ensure an attentive audience, the "rent seekers" bring their checkbooks to make sizable campaign or PAC contributions.

It's not a new practice. Adam Smith highlighted this practice back in 1776. In *The Wealth of Nations* he wrote, "people of the same trade seldom meet together, even for merriment or diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices."

Even if one agrees that some products and services should be protected, imposing large tariffs gives a green light to every other company or industry hoping to use government power to protect it from competition. That's the swamp, or what's known as "crony capitalism."

A Tariff's Biggest Impact Is Downstream

Tariff defenders typically try to downplay the price-increasing impact of tariffs, even though the whole point of imposing tariffs is to increase the price of an imported product or service high enough to discourage domestic consumers from buying it.

For example, Commerce Secretary Wilbur Ross recently told CNBC, "In a can of Campbell's Soup, there are about 2.6 pennies worth of steel. So if that goes up by 25 percent, that's about six-tenths of 1 cent on the price on a can of Campbell's Soup."

However, George Mason University economist Don Boudreaux points out that Americans buy more than 440 million cans of Campbell's soup each year. So by Ross's logic, Americans would spend $11 million more on Campbell's Soup—money they can't spend on other goods and services.

Tariff defenders also seem to ignore what might be called a multiplier effect that occurs downstream.

President Trump's steel and aluminum tariffs are being imposed on raw products that are purchased by companies that manufacture other products. That process could go through several iterations before finally reaching the consumer market.

Suppose ABC Co. uses $100 of steel (at pre-tariff prices) in manufacturing its products. And the company pays an employee $100 in wages to complete that process. The company has $200 invested and, seeking a 10 percent profit, sells the completed product for $220.

But under the Trump tariffs, the company must pay at least $125 for the same imported product. After adding its $100 in labor, the company now has $225 in out-of-pocket costs invested. To maintain its 10 percent profit, it much charge $247.50—$27.50 more than it had been charging.

If ABC sells to other manufactures who buy the product and then make their own value-added changes, the process could be repeated, perhaps several times, before the product finally reaches consumers.

President Trump hopes to protect 140,000 steelworkers' jobs; but there are an estimated 6.5 million downstream workers in steel-dependent industries—not to mention millions of consumers—who will feel the brunt of his protectionism.

Conclusion

President Trump has repeatedly boasted that his historic tax cut legislation helped millions of Americans, but his tariffs (i.e., tax increases) will reduce at least some of the economic growth that could emerge from the tax cut law.

The better approach is for the president to give his tax cuts time to work. There is a good chance they will boost economic growth and make U.S. companies more competitive globally—which was the whole point of tax reform—not by raising their prices, as tariffs do, but because lower taxes and fewer regulations allow them to lower their prices significantly.

Merrill Matthews is a resident scholar with the Institute for Policy Innovation.

Institute for Policy Innovation: 1320 Greenway Drive, Suite 820 Irving, TX 75038

www.ipi.org phone: 972-874-5139 email: ipi@ipi.org