IMPACT OF TARIFFS AND TRADE WARS ON ECONOMY

JEWEL P JOSEPH[1] **JOEL MOHAN[2]** **REYONS STEEPHEN[3]**
B.Com F&A, Department of Professional Studies, Christ University, Karnataka, India

DAMODHAR JANARTHANAN[4]
Analyst, KPMG

Abstract

Tariffs are taxes imposed by the government on goods and services imported from other countries to protect their domestic goods and services from foreign competition. Tariffs act as a means of restricting trade from particular countries. Imposing or raising tariffs on imports by countries often lead to trade wars. A trade war occurs when one country (country A) imposes tariffs on another country's (country B's) imports in retaliation to country B raising tariffs on country A's imports. The purpose of this paper is to determine the impact of tariffs and trade wars on economies and how it affects imports and exports between countries.
Keywords: Tariffs, tax, Government. Goods, Services, Competition, Trade War

Introduction

In the simplest terms, tariff means tax, charged on the products imported to the country to make them expensive and thereby encouraging the local trade. Very often when one country (say country A) imposes tariffs on imports from another country (country B) the exporting country (country B) also retaliates by imposing tariffs on the goods imported by it from the former (country A). This is what is called a trade war.

Tariffs are used by countries to

I) **Protect its customers**: If the government feels that any imported product could endanger its population then it may impose high tariffs on the product to prevent people from buying or consuming the product.

II) **Infant Industries**: If the government of a country wants to foster growth in a particular industry then it would impose tariffs on goods imported. This increase the prices of imported goods and creates a domestic market for domestically produced goods. It also allows the industries freedom from competitive pricing of imported goods.

III) **Increased Employment**: Charging tariffs on imports promotes domestic production of goods as imports become costlier. This opens up many employment opportunities.

IV) **National security**: Many times tariffs are used to protect industries of strategical importance to the country, for example industries supporting national security. It is a way of protecting the country's trade.

V) **Retaliation/ trade wars**: Country's may use tariffs as a retaliation technique if they feel that a trade partner is not playing by the rules.

TYPES OF TARIFFS:

Specific tariffs: Specific tariff refer to a fixed fee levied on a single unit of an imported good. This fee varies on the type of good imported. Example: a country could levy $ 15 tariff on a pair of shoes imported, but levy a tariff of $300 on a computer imported.

Ad Valorem Tariffs: The phrase ad valorem is derived from Latin and means "according to value". This tariff is levied on a good based on a percentage of that's goods value say 15%.

Tariff affects countries both positively and negatively. This research aims to determine the impact of tariffs and trade wars on the economy of a country.

REVIEW OF LITERATURE

(Wells, 1932)

Instead of promoting cooperation in commerce the great depression has revived nationalism even more strongly. Instead of reducing tariff barriers, they have been raised, duties imposed, restrictions revived and new devices invented for hampering flow of goods from one country to another. Countries have experienced a loss of exports due to this. A huge imbalance between exports and imports have been created. Many conferences were held to abolish such restrictions and prohibitions and to arrive at a mutual tariff plan benefitting everyone but these conferences were to a great extent a failure. Every country in their quest to protect their domestic markets have been unwilling to fully let go of barriers and restrictions.

(Richard, 1973)

The subject of this paper is predicting the impact of tariff manipulation on the country which changes the tariff and other countries involved in imports and exports with each other. This paper deals with the problem of quantifying the impact of tariff changes on the level of imports. This study divides the world economy into 3 groups

A. Aggregate of importing countries which are simultaneously changing tariffs on commodities
B. Aggregate of the exporting countries to which tariff changes are applicable
C. A group of all other countries

The study estimates the price elasticity of A's demand for import of the commodity and B's supply of exports of the commodity. It then derives an expression in which two elasticities and the tariff change may be combined to obtain an estimate of change in A's imports.

(John, 1931)

United States is considered one of the greatest trade free country in the world. If conditions in the US were similar to that in Europe mass production would have been impossible. Development of large business corporations would have been impossible. After the war one country after another adopted higher tariffs. In their international meetings businessmen and bankers went in opposition to these policies. Export trade in US has declined over the years and the influence of tariff changes behind this decline cannot be denied. Countries like Canada use prohibitive barriers to counter countries that use prohibitive barriers against them. Unites States is not the only offender in enacting extreme and unwise tariff rates. An effort by lending countries of the world to do away with tariffs would be advantageous. As a nation which has the largest export business in the world, the US bears the responsibility to contribute for a better international adjustment of this very annoying and disturbing tariff problem.

(Riezman, 1982)

This paper uses game theory to analyse the problem of tariff retaliation. Countries opting for tariff policies can be taken to be players in a game. Any change in tariff rates would evoke a response from rivals. Every country needs to decide a tariff strategy which considers the possibility of a retaliation. Free trade though considered best will not be chosen when countries behave strategically. This study uses the framework of bilateral monopoly to interpret results. Each country uses tariff policies to secure advantage over its rivals. Free trade will not be chosen if gains from free trade are unequally distributed. Results show that cooperation alone will not lead to free trade. This study suggests that in order to attain free trade, change in negotiating rules need to be made so that each country chooses free trade out of their strategic interest.

(Edward, 2002)

The US tariff system hits countries that deal in cheap goods, in particular poor countries in Asia, much harder than others. Tariff on European exports barely exceed one percent. Developing countries like Malaysia which specialize in Information Technology products, gets the same low rates. Natural resources exporters such as Saudi Arabia and Nigeria also get charged the same low rates. China, Thailand and Brazil faces rates between two and four percent but this is still not high. Least developed Asian countries like Bangladesh, Cambodia, Nepal, Mongolia and a few others who export clothes to the US face tariff rates of 14.6 percent which is 10.15 times higher. The US system is not the only bad system. European tariffs on clothes, shoes and food are also high and the European Union tariff collection is less transparent and accessible compared to the US tariff system. Other countries having bad tariff policies is no excuse or reason for Americans to adopt them. A system that makes the poor pay higher than the rich is an ethical scandal and very big problem. The facts are clear and reform is a question of political will.

STATEMENT OF PROBLEM

Tariffs raises prices of imported goods, making imports more expensive than domestically available goods. Increased cost of imports reduces their demand. The end result of tariffs is less exporting opportunities for producers and higher prices for consumers. In the long run tariffs reduces the global international trade. It increases the trade deficit. Trade deficit is the difference in the value between the import and export between two countries (Trade deficit = Total value of imports – Total value of exports). This further leads to a fiscal deficit. Fiscal deficit occurs when the government is having more trade expenditure than the trade income excluding borrowings, for the country. Tariffs reduce quantities of goods and services imported into a country which results in lower income, increased unemployment and lower economic output. It results in lower income for both owners of capital and workers. Analysts believe that many times businesses look for ways to overcome increased costs due to tariffs by reducing production costs and this affects the quality of products. Tariff policies of countries often lead to trade wars. Trade wars hurts the income of countries involved in the dispute. Trade wars create an imbalance between exports and imports of countries. It also affects the currency valuations of the countries. Tariffs and trade wars slow down economic growth and affects the relationship between countries.

FINDINGS AND SUGGESTION

THE IMPACT OF TARIFFS ON THE UNITED STATES

KEY FINDING

- Tariffs raise prices and reduce the quantity of goods and services for businesses and consumers in the U.S. This results in lower income, increased unemployment and reduces the economic output.
- Free trade and investments has largely contributed to U.S growth, but the U.S still maintains duties on several categories of goods. Highest tariffs being on agriculture, textiles and footwear.
- The Trump administration has imposed tariffs on imported solar panels, washing machines, aluminium and steel. It plans to impose tariffs on Chinese imports and import of automobiles.
- These tariffs will lower GDP, wages and employment in the long run. It will make the US tax code less progressive because the increased tax burden would ultimately fall the hardest on lower and middle- income households.
- Instead of erecting barriers to trade that will cause negative economic consequences, policy makers should promote free trade.

Openness to trade and investment has in a great way contributed to US growth, but the country still maintains tariffs on many items of goods. The overall effect of these tariffs is low, but varies across categories of goods.

Academic studies have quantified the costs of tariffs and has shown that tariffs often fail to achieve their objectives (Lincicome, 2017). A study of tariffs which took place in 1990 determined that annual consumer cost per American job saved range from $100,000 to over $1 million with an average of $ 170,000 (Hufbeaur Claude & Elliot Ann, 1994). A recent study analysing the tariffs imposed on steel by George W. Bush administration that in the first year of imposing tariffs, more Americans lost their jobs due to high steel prices (200,000) than the number employed by the steel industry (187,500)(York, 2018).

WIDE VARIETY OF TARIFFS MAINATAINED BY THE UNITED STATES

The United States maintains many tariffs on a wide range of goods. The United States international Trade Commission (USITC) publishes the Harmonized Tariff Schedule, which contains 99 chapters of various tariffs that apply to different categories of goods *(United States International Trade Commission, "Harmonized Tariff Schedule")* https://hts.usitc.gov/current.

The USITC maintains a tariff database, reporting statistics that include the value of imports as well as calculated duties by commodity.

In 2017, the total value of imports was $2.3 trillion and total estimated duties were $33.1 billion, having an average tariff of 1.42 percent. *(United States International Trade Commission, "Interactive Tariff and Trade DataWeb", April,2018)* https://dataweb.usitc.gov/. Though the average tariff looks small, individual goods are subject to much higher trade barriers.

In 2017, the United States imported $109.5 billion worth textiles and textile articles and paid $12.6 billion in tariffs on the imports, at a tariff rate of 11.5%. Within the category of imported goods, certain categories faced higher taxes. The rate on knitted or crocheted apparel and clothing accessories was more than 14% in 2017. *(United States International Trade Commission, "Interactive Tariff and Trade DataWeb", April,2018)* https://dataweb.usitc.gov/.

The Harmonized Tariff Schedule shows that in certain cases higher rates may apply. The maximum rate of duty that applies on Men's or boy's overcoat , carcoats, capes, cloaks, anoraks (including sky jackets), windbreakers and similar articles, knitted or crocheted etc. is 72%. *(United States International Trade Commission, "Harmonized Tariff Schedule (2018 HTSA Revison 5)," Chapter 61, 61-4)*

Tariffs above 25% ad valorem are concentrated in agriculture (primarily diary, tobacco and vegetable products), footwear and textiles. 22 tariff lines connected to agricultural products carry import duty rates of more than 100%.

Source: United States International Trade Commission, "Interactive Tariff and Trade DataWeb," https://dataweb.usitc.gov/

Section	**Customs Value**	**Calculated Duty**	**Average Applied Rate**
XI: Textiles and Textile Articles	$109.5	$12.6	11.53%
VIII: Raw Hides and Skins, Leather, Furskins and Articles Thereof; Saddlery and Harness; Travel Goods, Handbags and Similar Containers; Articles of Animal Gut (Other Than Silkworm Gut)	13.8	1.4	10.20%
XII: Footwear, Headgear, Umbrellas, Sun Umbrellas, Walking Sticks, Seatsticks, Whips, Riding-Crops and Parts Thereof; Prepared Feathers and Articles Made Therewith; Artificial Flowers; Articles of Human Hair	30.7	3.1	10.09%
All Sections	**2,313.0**	**33.1**	**1.42%**

Though tariffs generated revenue of $33.1 billion, high rates on certain categories of imports creates distortions in the economy.

CONCLUSION

Historically, the United States has led the movement towards free and open trade. It however maintains high tariffs on certain categories of goods.

How tariffs affect prices?

Tariffs increases the price of imported goods. As a result of increased price of imported goods domestic producers are not forced to reduce their prices due to reduced competition. This leaves consumers paying higher prices.

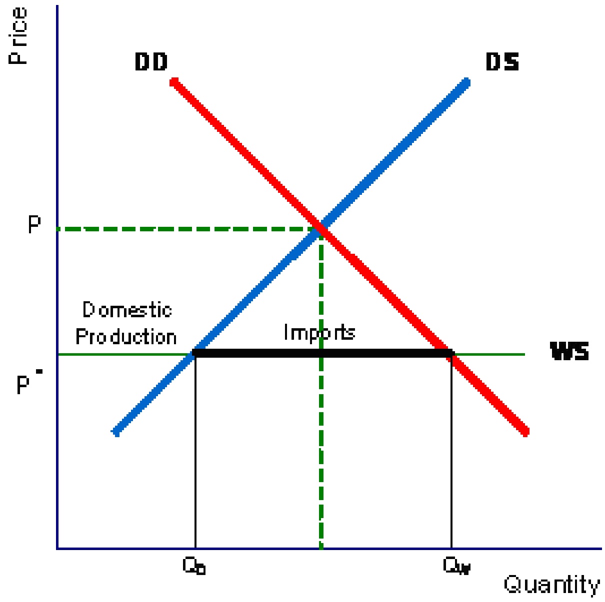

FIGURE 1

The graph shows world trade without any tariff.

DS – Domestic Supply

DD – Domestic Demand

P – Price of goods at home

P* - World Price

At lower price (World price – P*) consumers will consume Qw worth of goods, but because the home country can produce only upto Qd, it must import Qw – Qd worth of goods.

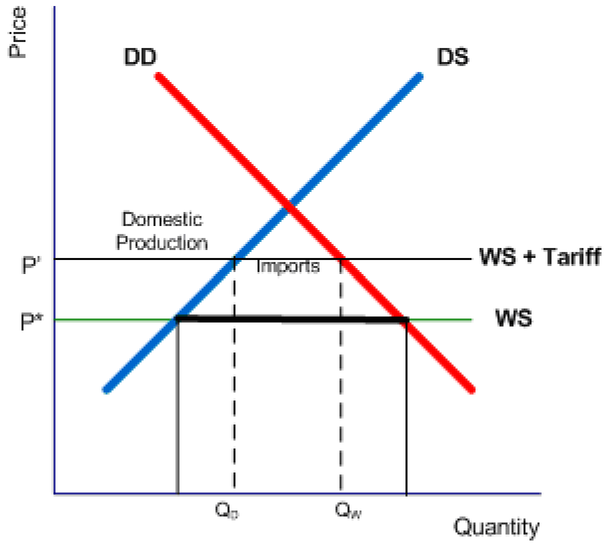

FIGURE 2

When tariffs are put in place, the effect is increase in prices and limit on volume of imports.

Price increases from non-tariff price P* to P’. Because of increase in price, domestic companies are willing to produce the goods, hence Qd moves right. This also shifts Qw left. The overall effect is reduced imports, increased production and higher consumer prices.

SMOOT – HAWLEY TARIFF ACT

The Tariff Act of 1930 commonly known as the Smoot-Hawley Tariff Act was an Act imposing protectionist trade policies proposed by Senator Red Smoot and Representative Willis C. Hawley and was implemented on June 17, 1930. The Act imposed tariffs on 20,000 imported goods.

The tariffs under the Act were the second highest in US history in 100 years exceeded only by the Tariff of 1828. The implementation of the Act and the retaliatory measures of American trading partners were major factors for reduction of exports and imports by more than half during the depression(Eckes, Alfred E., 1995).

SPONSORS AND LEGISLATIVE HISTORY

By the late 1920s US economy had made exceptional gains in productivity due to electricity which was a key factor in mass production. Horses and mules were replaced by motor cars, trucks and tractors. Farmlands previously used for feeding horses and mules were now used for agricultural production. Nominal and real wages increased but it did not keep up with the productivity gains. This resulted in overproduction and under consumption. Senator Smoot proposed that imposing tariffs on imports would help overcome this problem. The US at that time was running a trade account surplus, imports were steadily rising but exports were rising even faster. However food exports had been falling and was in trade deficit, but the value of food imports were a little over half the value of manufactured imports.(Berdreau, 1996).

As the world economy fell into the first stages of the Great Depression in 1929, the main goal was to protect American jobs and farmers from foreign competition. Reed Smoot proposed to increase tariffs within the US in 1929 which came to be known as the Smoot- Hawley Tariff Bill. The house passed a version of the Act in May 1929, increasing tariffs on agricultural and industrial goods.

RETALIATION

There were threats of retaliation by other countries long before the bill was enacted in June, 1930. As it was passed in the House of Representatives in May 1929, boycotts broke out and many foreign countries retaliated by increasing rates on American products. By September 1929, the Hoover administration had received protest notes from 23 trade partners, but these threats were ignored.("The Battle of Smoot-Hawley," 2008)

In May 1930, Canada, the country's most loyal trading partner, retaliated by imposing tariffs on 16 products which accounted for 30% exports of US to Canada. Canada forged closer economic links with the British Empire via the British Empire Economic Conference, 1932. France and Britain protested and became trade partners. Germany developed a system of trade via clearing. In 1932 with depression having worsened for the workers and farmers, Smoot and /Hawley lost their seats in the election that year.

AFTER ENACTMENT

At first the tariffs imposed seemed to be a success, according to Robert Sobel a historian. "Factory payrolls, construction contracts, and industrial production all increased sharply." When the Creditanstalt of Austria failed in 1931, the global deficiencies of the Hawley – Smoot tariff became apparent.(Sobel, 1972)

US imports decreased 66% from $4.4 billion in 1929 to $1.5 billion in 1933, and exports decreased 61% from $5.4 billion to $2.1 billion. GNP fell from $103.1 billion (1929) to $75.8 billion (1931) and bottomed out at $55.6 billion in 1933. ("Bureau of the Census, Historical Statistics Series F-1")

Imports from Europe decreased from $1.3 billion in 1929 to just $390 million in 1932, while US exports to Europe decreased from $ 2.3 billion in 1929 to $784 million in 1932. Overall world trade decreased by some 66% between 1929 and 1934 (U.S, 2003)

Jakob B. Madsen (2002) using panel data estimates of export and import equations for 17 countries estimated the effects of increasing tariff and non-tariff barriers on worldwide trade during 1929-1932. He concluded that international trade contracted around 33% overall.

The new tariff imposed an effective tax rate of 60% on more than 3,200 products and materials imported into the United States, quadrupling the previous tax rates on individual items, but raised the average tariff rate to 19.2 %.

Unemployment was at 8 % in 1930 when the tariff was passed, it did not decrease due to the new tariff. It increased to 16% in 1931 and 25% in 1932-33. ("Historical Statistics of the United States," 1957)("U.S Bureau of the Census")("Social Science Research Council (1960)"). There is however contention whether this rise can be attributed necessarily to the new tariffs.(Irwin, 2018).

In 1929 imports were only 4.2% of the United States' GNP and exports were 5.0%.

END OF THE TARIFFS

In 1932, democratic campaign platform pledged to lower tariffs. The Reciprocal Trade Agreements Act of 1934 was passed. This Act enabled tariff reduction negotiations on a bilateral basis, and treated tariff agreement as a regular legislation, requiring a majority, rather as a treaty requiring two-third vote. The tit-for-tat responses of other countries had contributed to reduction of trade in the 1930s. After World War II multi-lateral trading agreements were entered into to prevent a similar situation in future.

BIBLIOGRAPHY

1. Wells, P. (1932). TRADE , TARIFFS , THE DEPRESSION. *Foreign Affairs Vol10, 10*(3), 391–401.
2. Richard, B. (1973). Estimating the Impact of Tariff Manipulation : The Excess Demand and Supply Approach Author (s): Richard Blackhurst Source : Oxford Economic Papers , New Series , Vol . 25 , No . 1 (Mar ., 1973), pp . 80-87 Published by : Oxford University Press Stabl. *Oxford Economic Papers*, *25*(1), 80–87.
3. John, F. H. (1931). IT seems to me that no fair-minded business man or student, *14*(3), 41–47.
4. Riezman, R. (1982). Tariff Retaliation from a Strategic Viewpoint. *Southern Economic Journal*, *48*(3), 583–593.
5. Edward, G. (2002). Toughest on the Poor. *Foreign Affairs, Vol. 81, No.6, 81*(6), 9–14.