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# A 10-Point User Guide to the Trump Tariff Wars

BY ROBERT D. ATKINSON AND STEPHEN J. EZELL | JULY 2018

*Getting to a new "third way" trade approach will require globalists and nationalists to become strategic globalists—that is, to embrace global integration while also being forceful about pressing the scofflaws and mercantilists to shape up or be excluded.*

President Trump has announced plans to impose tariffs on steel and aluminum from a wide variety of countries, on $50 billion worth of Chinese exports (including products ranging from aircraft to chicken incubators), and has floated the idea of placing tariffs on automobile imports as well. The president justifies all of this on the grounds that other nations are not acting fairly, because if they were then the United States wouldn't be running significant trade deficits. President Trump recently tweeted that: "The United States is insisting that all countries that have placed artificial Trade Barriers and Tariffs on goods going into their country, remove those Barriers & Tariffs or be met with more than Reciprocity by the U.S.A. Trade must be fair and no longer a one way street!"[1] Trump's approach has drawn widespread criticism, sparking a debate in which partisans for and against the president's policies have made all sorts of claims and counter-claims. This briefing untangles the prevailing arguments and sets the record straight on 10 important points of fact.

### 1. Tariffs aren't a cost to the economy as a whole; they're a transfer payment.

One of the main arguments made by tariff opponents is that they are a cost. As none other than White House adviser Peter Navarro wrote in his 1984 book *The Policy Game,* "The biggest losers in the protectionist policy game are consumers."[2] More recently, in the wake of the Trump administration's tariff announcements, *Time Magazine* published an article purporting to list "All the Products That Will Cost You More Because of Trump's Trade War."[3] But tariffs are not a cost for the economy as a whole; they are a transfer payment.

In other words, they take money from one part of the economy and move it to another. Yes, consumers will pay more for certain products because of tariffs, but government revenues will increase. If the federal government uses those revenues to reduce taxes an equivalent amount (or increase public spending), then on average Americans are no worse off, at least in a static sense, not taking into account economic effects of tariffs on production. Or, if the government uses the revenues to reduce the national debt, then current consumers are worse off, but future Americans are better off.

### 2. There's a difference between tariffs on consumer products and tariffs on capital goods.

One of the most striking differences between the tariffs President Trump announced on Chinese products and the retaliatory tariffs that China announced on the United States is that the former are largely focused on producer goods (motors, industrial parts, etc.), while the latter are focused on consumer goods (mostly food products). The reason for the former was clear: The administration understood there will be less political backlash from voters if they don't face immediate price hikes on the goods they buy every day. Tariffs on producer goods are more of a hidden tax, where prices go up only as companies pass on their increased input costs. Consumers could very well blame "profit-hungry" corporations for these price hikes rather than the administration. In contrast, one reason China placed tariffs on consumer goods is that it didn't want to slow capital investment by Chinese businesses. The Information Technology and Innovation Foundation (ITIF) modeled the impact on U.S. productivity of placing a tariff on information and communications technology (ICT) products like computers, servers, smartphones, semiconductors, software, and scientific instruments. Under a 25 percent tariff rate, economic growth would slow by 0.105 percent in the first year after tariff implementation, and the economy would forego a cumulative $332 billion in economic growth over the ensuing 10 years.[4]

### 3. Tariffs can bring economies into or out of equilibrium.

One of the main arguments economists make against tariffs is that by artificially raising the prices of certain goods an economy consumes too few of them, or it consumes more of them from less-efficient producers, thereby lowering GDP. In other words, tariffs distort allocation efficiency. However, if tariffs are a response to foreign subsidies they can correct an existing distortion. As Navarro argues, the "obvious problem with this approach is that it ignores that the starting point of the analysis is typically a market highly distorted by unfair subsidies which is far from the optimal outcome. On this basis alone, a tariff can move the market towards a more efficient solution."[5]

This is surely true. For example, if China subsidizes solar panels exports by 40 percent, then placing equivalent tariffs on solar panels would bring the global market more into equilibrium. But the problem is that the Trump tariffs don't appear to be surgically designed to restore equilibrium. Where is the distortion from Canadian steel? There is no evidence that the Canadian government is subsidizing steel production. Where is the distortion from Japanese autos? Again, there is no evidence that the Japanese government is subsidizing auto production. Tariffs directed at these kind of products and nations create distortions and reduce allocation efficiency. If President Trump's tariffs truly were directed at countries using innovation-mercantilist policies like massive subsidization of domestic industries, this would be one thing, but unfortunately the administration's passion for tariffs has broadened well beyond these types of potentially justifiable applications.

### 4. Tariffs can be a tax on domestic production.

When tariffs were a core part of the U.S. economic system—largely from the founding of the republic until World War II—trade in manufacturing was a much simpler system. By the early 1900s, the United States mostly imported natural resources and processed them into manufactured goods, some of which it then exported to other nations. Tariffs were thus largely applied on goods produced by foreign companies. But over the last half century the global manufacturing system has evolved into a complex web of interlocking supply chains, such that it is not uncommon for a company to make part of a product in the United States, ship it to another country for further processing, and then back to the United States for final processing and then for sale. Take semiconductors. The United States is the world's leading producer of semiconductors, doing virtually all of the research and development (R&D), chip design, and much of the advanced production in the United States. As the pioneer of globalized supply chains, the American chip industry since the 1960s has shipped nearly all of its finished integrated circuits to China and other Asian countries for final assembly, packaging, and testing. While many of these chips stay in Asia for final consumption, some are sent back to the United States, mostly for consumption by U.S. industrial firms that integrate semiconductors, such as auto companies.[6] Unlike R&D, design, and fabrication, which are all high-value-added activities, assembly, packaging, and testing represent very low-value-added processes. So if the Trump administration follows through with its threat to impose tariffs of 25 percent on semiconductor imports it will end up taxing mostly domestic production. To see why, consider that packaging and testing normally involve about 10 percent of the total cost of a semiconductor. So, if a U.S. company like Intel or Texas Instruments ships $9.1 million worth of almost-finished semiconductors to China for reimport to the United States, and $900,000 in value is added in China, then the U.S. government would impose a tariff of $2.5 million (25 percent of $10 million), not a tariff of $225,000 (25 percent of $900,000). The result would be that U.S. semiconductors become significantly more expensive, leading to two possible results: either (a) a shift in test and packaging capacity to a nation like Vietnam, so that the Chinese facilities remain, but they supply markets outside the United States; or (b) a reduction in domestic demand and loss of competitiveness by U.S. consumers of semiconductors (i.e., autos, robotics, and aerospace).

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### 5. Tariffs help some domestic producers but often hurt others.

To be sure, what tariff opponents usually ignore is that they can help boost domestic producers who become protected by a tariff shield. Steel tariffs will likely help boost domestic steel production. But they also will hurt other producers that depend on imported products. For example, many industries that use steel will face higher costs, making it harder for them to compete globally. Moreover, for many industries, higher tariffs will not help restore domestic production, because most production is already offshore. In this case, they will lead to shifts from one foreign nation to another. For example, it's unlikely that tariffs on Chinese ICT exports to the United States would induce ICT producers to move considerable ICT production back to the United States. With an extensive supplier base already in Asia for ICT goods production, tariffs on Chinese ICT imports would likely mean a shift in production to other similarly low-cost Asian nations, such as Indonesia, Malaysia, or Vietnam, which U.S.-located ICT producers would then source from instead.

### 6. Tariffs invite easy retribution.

Very few nations, if any, are willing to accept unilateral tariffs from the United States without responding in kind. Indeed, one of the major problems with unilaterally applied tariffs is that other nations normally don't sit back passively and "take it." They retaliate tit-for-tat. Navarro recognized that in 1984 when he wrote, "The clear danger of this trend [protectionism] is an all-out global trade war; for when one country excludes others from its markets, the other countries inevitably retaliate with their own trade barriers. And as history has painfully taught, once protectionist wars begin, the likely result is a deadly and well-nigh unstoppable downward spiral by the entire world economy."[7]

And of course, we are now seeing this with Canada, China, and the European Union all announcing plans to impose retaliatory tariffs. In some cases, this will reduce U.S. domestic production. For example, the Canadian government has announced its list of tariffs to implement if the Trump administration follows through on its steel and aluminum tariffs, and they are targeted at industries, such as ketchup, where there is already domestic Canadian production that can take up the slack of reduced U.S. imports.[8] In other cases, foreign tariffs will lead U.S. producers to shift production out of the United States to foreign countries, either to those putting up the tariffs or to others not covered by the new foreign tariff. This is much easier for many companies to do today than it was a century ago because they already have plants in multiple companies. This is essentially what has happened with the recent announcement by American icon Harley Davidson. Faced with retaliatory tariffs from the European Union (EU) adding $45 million in export costs, on top of the approximately $20 million from higher steel costs, and the need to sell in Europe, Harley announced it would produce motorcycles for the European market outside the United States, so it could export to Europe largely tariff-free.[9]

### 7. Tariffs applied to many nations fail to deal with the most serious issues and challenges in the global trading system, which are "behind-the-border" challenges from a select number of nations.

There are three main positions regarding global trade. The first, which is the general consensus in Washington, is that global trade is almost always an unalloyed good, even if there is rampant and systematic mercantilism being conducted by some of our trading partners. The second, which appears to be the Trump position, is that the global trading system as currently construed is structured against us and that tariffs on most nations and a large share of products represent an appropriate response. Indeed, President Trump recently stated that the "European Union is just as bad as China on trade."[10] For the Trump administration, and many globalists, it appears that there are only these two positions. Indeed, former top Trump advisor Steve Bannon sees trade politics as "globalist vs. nationalist" positions.[11]

But there is a third position—what might be called strategic trade enforcement—that focuses on particular countries and particular challenges. In this case, the major trade challenge facing the U.S. economy is from China. As ITIF showed in its "Global Mercantilist Index," a report ranking 55 nations on the extent of their mercantilist policies and practices, there are significant differences amongst countries, with China not unexpectedly ranking the worst, and nations like Japan, Germany, and the United Kingdom—all nations Trump has placed tariffs on—ranking among the least-mercantilist in the world.[12] The focus of U.S. enforcement action should be on the worst mercantilist nations, not the least. Moreover, tariffs are not always the right tool. Yet Mr. Navarro says that, "The only line of defense against such unfair trade practices are countervailing duties and tariffs." But as ITIF has articulated, there are a wide array of tools beyond tariffs that can be effective in addressing these behind-the-border distortions.[13]

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### 8. Tariffs broadly applied to many nations hurt our ability to form alliances against China.

As ITIF has argued, China constitutes the largest threat to not only the global trading system, but also to U.S. innovation and national security. Yet, because of the way the World Trade Organization is designed, it's very difficult to leverage the organization to roll back China's massive and egregiously unfair trade practices. But a tit-for-tat trade war fought with tariffs is unlikely to achieve that goal. The odds of being able to pressure China to roll back its unfair practices decline dramatically without the help of allies. But the Trump tariffs and threats of tariffs on U.S. allies have not only made it extremely unlikely that allies will work with us, they have perversely pushed our allies to form closer alliances with China against "U.S. protectionism." It is beyond ironic that Japanese Prime Minister Shinzo Abe feels that he must form a closer partnership with China to uphold the post-War, free trading system.[14] Likewise, China and the European Union have accelerated negotiations and are close to completing a bilateral investment treaty.[15]

### 9. At best, tariffs are a tactic to create leverage.

Perhaps one of the most troubling aspects of the Trump administration's trade policy is that it is not clear, at least from the outside, what the strategic goal is. Is it to not run a trade deficit with any nation? Is it to restore production in traditional sectors, such as steel and autos? Is it to pressure China to roll back egregious practices that threaten America's advanced industries? If it's the former, then it makes little or no sense, as at best the goal should be to balance trade globally, not with every single country. If it's the second, then it ignores the fact that the key to America's future, including militarily, is its ability to compete in technologically advanced industries. If it's the third, then at best tariffs might be able to pressure China to change unfair domestic practices related to its "Made in China, 2025" strategy. But that will only happen if the Trump administration is clear that this, rather than more soybean and liquified natural gas exports, is the goal. Moreover, there are steps that can be taken that are not only likely to be more effective at getting China to change its behavior but that also will not diminish America's global standing.[16]

### 10. Employed unilaterally, tariffs undermine the integrity of the global trading system.

As Navarro argued in 1984, unilateral tariffs will be a blow to the "heart of an international world order that since World War II has successfully changed the aggressive struggle among nations for world resources and markets into a peaceful economic competition rather than a confrontational political or military one."[17] The need to challenge mercantilism was always constant, although, unfortunately, past U.S. administrations' efforts to fight it have been woefully inadequate, largely because they bought into the Washington trade consensus which held that fighting mercantilism was tantamount to flirting with domestic protectionism. But fighting mercantilism does not mean abandoning the global project for free trade. In fact, without U.S. leadership it will be much more difficult to move the global trading system more toward free trade. President Trump's actions remove or at least weaken U.S. leadership.

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What many globalists seem to forget is that America's experience as the champion of global free trade is relatively new, dating only to the period after World War II. Prior to that, tariffs had long been justified as a key development tool, championed largely by northern and midwestern Republicans as a way to help industrialize and modernize the nation, though often opposed by agrarian Democrats in the South and West. In fact, tariffs averaged around 30 percent of the price of imports for much of U.S. history until the early 1900s.[18] Indeed, when Herbert Hoover signed the Smoot-Hawley tariff legislation in 1930 he stated, "There are certain industries which cannot now successfully compete with foreign producers because of lower wages and lower cost[s] of living abroad."

The shift to a globalist approach after WWII was not something all elites embraced. Indeed, a substantial fraction of the Republican party continued to embrace isolationism and protectionism. Senator Robert Taft, nicknamed "Mr. Republican," stated in 1949 that, regarding his vote to oppose the United States joining NATO, "I do not believe any policy which has behind it the threat of military force is justified as part of the basic foreign policy of the United States except to defend the liberty of our people."[19] And it was largely the Republican Party, which controlled Congress after 1946, that torpedoed the U.S. entry into the International Trade Organization, the failed predecessor to the World Trade Organization.[20] Leading Democrats also embraced isolationism in trade and foreign policy. So, at one level, Trump's actions are consistent with an attempt to return to a pre-War world, with a dramatically smaller government, lower taxes, a significantly reduced role in the world, and a more autarkic, self-sufficient economy.

But while that approach might have been in America's interest before WWII, it most definitely is not in the country's interest in the 21st century. The U.S. government's policy can't only be about "America First—take it or leave it," (or, "We're America, Bitch," as one Trump official reportedly stated).[21] The correct answer is no more a broad array of indiscriminate tariffs on U.S. allies and mercantilists alike than it would be withdrawing from the World Trade Organization, as President Trump has apparently said privately that he'd like to do.[22] Rather, it's got to be about "America First, as leader of a liberal, international economic order in which fewer nations embrace mercantilist practices," an approach which has actually produced tremendous wealth both for the United States and its allied trading partners throughout the post-War era. To be sure, the Trump administration is correct that it is time to target countries that would subvert that order through the virtually unchecked use of mercantilist policies that undermine fair trade and have cost the United States millions of thousands of jobs and hundreds of billions of dollars in trade deficits and lost economic opportunity. When the Trump administration's trade policy is focused on righting those wrongs, especially with help from U.S. allies, it's at its best. To get to that new "third way" trade approach will require globalists and nationalists to become strategic globalists—that is, to embrace global integration while also being forceful about pressing the scofflaws and mercantilists to shape up or be excluded.

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