

The wrong tariff for the wrong reason.

The incoming Trump administration is gearing up towards imposing substantial tariffs on all US imports. The new Treasury Secretary, Scott Bessent, has used the optimal tariff argument to justify such actions. The new head of the Council of Economic Advisors, Stephen Miran, citing our own work, proposes 20% as a “benchmark” for the US optimal tariff. We think this is a very bad idea.

The optimal tariff argument

The optimal tariff argument is hardly new. It is about as old as David Ricardo’s famous case for free trade.

The optimal tariff argument builds on the idea that countries have market power, and so can benefit from exercising it. Like a large firm that can increase its profits by manipulating how much it sells to its consumers and how much it buys from its suppliers, a large country may become richer by manipulating its volume of exports and imports. Export and import taxes are the tools to achieve this objective, with import tariffs far more common than export taxes due to various economic and political considerations.

To understand how the optimal tariff argument works, suppose that the US government imposes a tariff on French wine. Everything else being equal, US consumers would face higher prices and reduce their demand. This could put downward pressure on the prices at which French wine producers would be willing to sell, leading to overall gains for the United States that may now purchase wine from Bordeaux and other French terroirs at a discount at the dock, even though US consumers would still pay a higher at the supermarket since the price they pay has the tariff added on top.

How much market power does the United States have?

We expect large countries like the United States to have some market power. What’s less clear is: how much? This depends on several factors that are difficult to measure precisely. For example, market power depends on how easy it is for foreign exporters to find alternative markets. If French winemakers can no longer sell their products freely to US consumers, can they sell them to German or Chinese consumers? If so, the price of French wines won’t change much and the optimal tariff should be lower.

Additionally, success or failure in exercising market power cannot be evaluated purely from the impact of tariffs on US import prices. The ultimate goal of an optimal tariff is to make the United States richer by lowering the price of what it buys relative to what it sells, say iPhones and Teslas. This cannot be assessed without considering also how tariffs affect US export prices. These prices could increase if tariffs cause the US dollar to appreciate – in this case, the optimal tariff should be higher.

The uncertainty around these considerations leaves plenty of room for different tariffs to be optimal depending on one’s preferred trade model. The 20% number taken from our own study is only a “benchmark” in the sense that it comes out of the simplest trade model that one can write down. This makes it a great pedagogical tool in the classroom, not a useful guide for policy outside of it.

The wrong question to ask.

Many questions in economics are hard. “How much market power does the United States have?” is one of them. We have attended many lively seminars about the merits and shortcomings of various trade

models and econometric estimators designed to shed light on this question. We do not expect these seminars to become less lively in the years ahead.

Fortunately, “how much market power does the United States have?” is also the wrong question to ask. As a matter of academic debate, it is certainly interesting to understand why, in the absence of any international rules and institutions, a country may have incentives to exploit its market power by being protectionist. As a matter of actual policy, however, such considerations provide a misleading picture of what the overall impact of US tariffs would be. The reason is foreign retaliation.

The optimal tariff argument assumes that when foreigners face higher trade barriers in the United States, they sit idle, get poorer, and do not impose their own tariffs on US goods. This won't happen.

What's next?

Foreign retaliation isn't news to people in the new Trump administration. But they view tariffs as a game of chicken. Provided that the United States is committed to high tariffs, they believe that foreigners will choose to maintain their own tariffs low for fear of entering a costly trade war against the United States. The game of chicken, however, is the wrong metaphor to think about trade wars.

Trade wars are best viewed as a prisoner's dilemma. Instead of staying silent, prisoners are always tempted to testify against their partner in crime in exchange for a more lenient sentence. By doing so, however, they all end up in prison for longer. Similarly, because each country has some market power to exploit, they have incentives to raise trade barriers, regardless of what the other countries do. The problem is that, when they all do so, none of them succeed in making their imports cheaper and they all end up being poorer.

Over and over again, we have observed countries retaliate against US tariffs. In 1930, Canada responded to the Smoot-Hawley Tariff Act by imposing tariffs on US goods even before the Act went into effect. In 2018 and 2019, China responded to each wave of tariffs by the first Trump administration, targeting \$100 billion of US exports. This week, Canada announced that it was already preparing retaliatory tariffs on whiskey from Tennessee and orange juice from Florida. Mexico and the European Union made similar announcements.

The world trading system that emerged after World War II was designed precisely to keep countries' beggar-thy-neighbor impulses in check and avoid repeating the trade wars from the 1930s. It allowed countries to sustain trade cooperation for decades.

The world economy has changed. China has emerged as a new hegemon. It is natural for US economic policy to change and adapt to the new circumstances. But tariffs are not the powerful tool to solve all problems that the new Trump administration believes them to be. Retaining its dominance in high-tech sectors, regaining a foothold in new green sectors, and restoring prosperity to lagging regions, to name just a few, are critical goals for US economic policy in the years to come. A richer set of economic policies are needed, with tariffs playing at best an auxiliary role.

Pursuing a policy of raising tariffs would most likely lead to a new global trade war. Its consequences, unfortunately, are not hard to predict. It would mean less trade and, most importantly, less international cooperation on the big issues of the day: war, poverty, and climate change.

