What is a tariff? An economist explains

By Amitrajeet A. Batabyal, The Conversation, adapted by Newsela staff on 04.06.18
Word Count **1,091**
Level **1120L**

Image 1. The Lica Maersk, a container ship that transports goods for the country of Denmark, 2017. Container ships are massive vessels that can transport truck-size containers from country to country for the purposes of international trade. Photo from the public domain

In March, President Donald Trump slapped tariffs of 25 percent on imported steel and 10 percent on foreign aluminum. This caused worldwide concern and discussion about the wisdom of this action.

I am an economist who shares some of those concerns. However, I believe it's important to first understand what a tariff actually is and does before we can determine whether Trump's new trade barriers are good or bad.

Two Kinds Of Tariffs

A tariff, simply put, is a tax imposed on an imported good. There are two types of tariffs. A "unit" or specific tariff is a tax imposed as a fixed charge for each unit of a good that is imported, such as $300 per ton of imported steel. An "ad valorem" tariff is levied as a percentage of the value of imported goods, such as a 20 percent tariff on imported automobiles. Both tariffs act in similar ways.

Tariffs are one of the oldest trade policy instruments. A trade policy instrument is a practice a government can carry out in order to affect trade. In the U.S. the use of tariffs dates back to at least the 18th century. Historically, the main objective of a tariff was to raise money, or revenue. In fact, before the 16th Amendment in 1913 formally created the income tax, the U.S. government raised most of its revenue from tariffs.

These days tariffs mainly seek to protect U.S. industries from foreign competition, as well as raise revenue for the government.

Examining A Tariff's Impact

The impact of a tariff depends on the size of the country that imposes it. In terms of trade, a country is large or small based on its power to import or export products and its ability to influence world prices.

Ghana, for example, roughly the size of Minnesota with a population similar to Texas, is one of the world's top exporters of cocoa. Meanwhile, the Netherlands, slightly smaller than New Jersey, is one of the biggest importers of cocoa beans. Dutch factories turn those beans into chocolate. They also make them into cocoa powder and cocoa butter (a key ingredient in chocolate), which they sell to chocolate makers in other countries.

Therefore, both countries' trade policies can have a significant impact on the price of cocoa on global markets.

Let's imagine that the Netherlands had its own cocoa bean growers and wanted to protect their businesses. If the country imposed a tariff on imports of Ghanaian cocoa, there would generally be three effects.

First, the price of imported cocoa would rise in the Netherlands, making it more costly for consumers within the country. This would be bad news for Dutch chocolatiers since they are the world's biggest exporter of cocoa butter, a key ingredient of chocolate. Dutch chocolatiers also make cocoa powder and chocolate bars. It would also be bad news for Dutch citizens who eat a lot of chocolate.

On the other hand, higher import prices would be good news for Dutch companies and farmers that grow cocoa beans. Because the cocoa they produce would become cheaper than imported cocoa, consumers would buy more Dutch beans.

Second, because the Netherlands is a large importer of cocoa, the tariff would drive down the price at which Ghana could export that good. Economists call this a "terms of trade gain" for the country imposing the tariff. The tariff would force imports to actually become cheaper. However, Ghanaian growers and producers would make less money, and their economy would be hurt.

Finally, the amount of trade in the product between the countries would decrease. This is due to the fact that the Netherlands would import less cocoa and farmers in Ghana would produce less of it.

If the country charging the tariff is not a big player in that industry, however, things would be different. Let's imagine for a second that the Netherlands was not a big importer of cocoa beans. Then, there would only be two effects. The price of imported cocoa beans would go up for businesses in the Netherlands, so Dutch growers would sell more. There would still be less trade between the Netherlands and Ghana. But, in this case, the tariff would not hurt Ghana very much. Ghana would keep selling its beans to other countries at the same price as before.

Benefits And Costs

For a "large" country, the benefits of a tariff are mixed. Buyers within the country face higher prices. These are businesses such as Dutch cocoa butter makers and individuals who enjoy a tasty bar of dark chocolate. However, the domestic industry being protected benefits by becoming more competitive and selling more of its goods, while the government also gains a new source of revenue.

If the gains in terms of trade gain are large enough, then the country benefits from the tariff. But for a small country, its effect on the prices of the exporting country will be zero. In other words, the terms of trade gain is zero. Therefore, a tariff unquestionably makes it worse off, because it will just make cocoa more expensive for Dutch consumers.

Political Economy Of Tariffs

A large country can, in some cases, be better off with a tariff. This fact has led some to suggest that such nations ought to, when necessary, impose "optimal tariffs" against countries they trade with. An optimal tariff leads to the highest advantage in the terms of trade gain. In the example, since the Netherlands is such a major buyer of Ghana's cocoa beans, the tariff could force Ghana to lower its price to the advantage of the economy of the Netherlands.

The problem with such strategic tariffs is that, in addition to frequently being illegal under international trade law, they can cause a harsh response. The other country is likely to respond with their own tariffs. Such tit-for-tat actions can easily descend into a trade war. This is in part why trade economists are typically against restricted trade and in favor of free trade.

Amitrajeet A. Batabyal is a professor of economics at Rochester Institute of Technology in Rochester, New York.