Reciprocal Tariffs

Historical Context, Theory and Implications

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Executive Summary

Reciprocity is an important feature of global trade. When countries negotiate a trade deal, they offer each other concessions that they agree are of equal value. The Trump administration has proposed a stricter view of reciprocity, in which the tariff rates between nations are equal in both directions. The administration argues that comparatively low U.S. tariffs place American businesses at a disadvantage in global commerce. However, economists believe that a completely reciprocal tariff schedule would be harmful for domestic companies and consumers. As the specifics of President Trump's reciprocal tariffs become clear, businesses should prepare for uncertainty and increased complexity in trading with foreign partners.

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I. Introduction

a. Definition of Reciprocal Tariffs

Tariffs are taxes domestic companies pay the federal government upon importing foreign goods and services. Importers pay a fee when a good enters the U.S., which is usually a percentage of the price of the good. The Harmonized Tariff Schedule of the United States (HTSUS) defines how merchandise should be classified and the associated tariff. "Reciprocal" tariffs, as used by the Trump administration, refer to tariff rates on foreign imports that are equal to the rates each trading partner places on American goods. Tariffs were once the primary source of income for the federal government. Today, however, tariffs account for less than 5% of federal revenue.

b. Historical Context and Evolution of Tariff Policies

During the 20th century, several developments in trade policy established a system of global trade that has drastically reduced tariff rates worldwide. The first was the adoption of a policy of nondiscrimination, also known as "most favored nation" (MFN). Originally, the U.S. set individual tariffs for each trading partner. If a lower rate were granted to one country, other countries would have to grant new concessions to receive the same treatment. This strategy created a complicated tariff schedule, as rates varied depending on type of good and country of origin. It also caused unintended friction with trading partners. Countries that already gave favorable treatment to American goods might nonetheless find themselves at a disadvantage as a result of U.S. negotiations with a third party. To remedy this, Congress began to implement MFN in 1923.[i] Under MFN, every country receives the lowest rate the U.S. grants any trading partner. This policy included the stipulation that higher penalties could be imposed on countries that discriminated against American goods. This change simplified both the tariff schedule and tariff negotiations while encouraging fair treatment by trading partners.

Despite the implementation of MFN, tariffs continued to rise both domestically and abroad through the 20's and early 30's. This culminated in the passage of the Smoot-Hawley Tariff Act of 1930, which was intended to protect farmers suffering from the Great Depression. This act increased U.S. tariffs to the second highest level in history. Other countries retaliated, and global trade fell by 65%. Most economists believe that this wave of protectionism worsened and prolonged the Depression.[ii] Curtailing this protectionism proved difficult. Tariffs were set by Congress, making change arduous and slow. Negotiations with other countries were often multilateral and failed to make much progress. In response, Congress enacted the Reciprocal Trade Agreements Act (RTAA) in 1934, allowing the Roosevelt administration to negotiate bilateral trade agreements.[iii] These negotiations used the principle of reciprocity, meaning that concessions were offered and received in a way that benefited both nations. The U.S. signed trade agreements with 29 countries under the provisions of the RTAA, dismantling the protectionism that had preceded it.[iv]

After WWII, the U.S. sought to create a multilateral institution built on the principles that had been so successful at promoting cooperation. Although implementation of the International Trade Organization failed, negotiations resulted in the creation of the General Agreement on Tariffs and Trade (GATT). In 1947, the U.S. and 22 other nations signed the GATT, committing to mutually negotiate lower tariffs and extend them to all other members under MFN. Over the following five decades, GATT members participated in eight rounds of negotiations as the number of signatories grew to over 100. In 1995, the Uruguay Round of negotiations led to the creation of the World Trade

Organization (WTO). The WTO incorporated the articles of the GATT, addressed a number of additional issues (such as intellectual property) and established the procedure for settling disputes.[v]

c. Importance of Reciprocal Tariffs in Modern Trade Agreements

Reciprocity is a basic principle of the WTO. However, this kind of reciprocity is different from the one proposed by the Trump administration. Under the GATT/WTO framework, reciprocity in general means that countries grant concessions of equal value to both negotiators. More specifically, reciprocity has been understood as negotiations that, for each country, result in changes in the volume of exports and imports that are equivalent. This principle is evident in the WTO dispute settlement procedure.[vi] If a member is found to have violated their commitments, the affected trade partners are permitted to retaliate by suspending concessions that are "equivalent to the level of the nullification or impairment".[vii]

II. Theoretical Foundations of Reciprocal Tariffs

a. Benefits and Arguments for Reciprocal Tariffs

The Trump administration has proposed a complete overhaul of the U.S. tariff schedule founded upon a stricter view of reciprocity. Under "mirror image" reciprocity, the U.S. would set tariff rates equivalent to those our trading partners apply to American goods. For example, the U.S. currently applies a 2.5% tariff on imported automobiles, while the EU charges 10%. Under President Trump's plan, automobiles imported from the EU would face a 10% duty to match the EU's rate. The administration argues that uneven tariff rates and unbalanced trade volume are unfair. In their proposal, the administration points to a few potential benefits to mirror image reciprocity. Other countries might be encouraged to lower tariffs on U.S. goods to avoid the increased rates. More importantly, the plan is intended to help balance the trade deficit. The administration sees trade policy as a major driver of the trade deficit: "closed markets abroad reduce U.S. exports and open markets at home result in significant imports, both of which undercut American competitiveness". They propose that the plan will decrease the deficit, thus promoting domestic industry, workers, and security.

b. Arguments Against Reciprocal Tariffs

Opponents of mirror image tariffs point to several potential downsides for American businesses, workers, and economic growth. They argue that individual duties for each trading partner will overcomplicate the tariff schedule, increasing confusion and administrative costs. The number of duty lines could increase by nearly ten times.[viii] Economists also point to the ways that higher tariffs can harm the economy. U.S. importers will face higher prices, which could be passed onto consumers. Industries downstream of imported inputs will face higher costs, which could reduce employment. Additional challenges could follow if foreign countries respond with retaliatory tariffs, reducing the competitiveness of American exporters. In regards to the trade deficit, most economists believe that trade barriers have little to no effect.[ix] Beyond potential economic impacts, proponents of the WTO argue that such a plan could undermine decades of established trade policy, introducing significant uncertainty into international trade.[x]

c. The Principle of Reciprocity in Trade Policy

Since the signing of the GATT in 1947, reciprocity has been a core feature of global trade. Reciprocal negotiations tend to lower trade barriers in a way that is beneficial to both parties. When countries set trade policy unilaterally, tariffs tend to increase. Higher tariffs benefit import-competing companies, who can coalesce and urge the government to protect them from foreign competition. However, the parties who would benefit from lower tariffs form a much larger and more diverse group that cannot organize and push for liberalization. Through reciprocity, a reduction of tariffs domestically will generate a corresponding reduction in foreign tariffs; in other words, countries reduce barriers to domestic markets in exchange for greater access to foreign consumers. This policy turns exporters into opponents of protectionism and provides the political will necessary to lower tariffs, increasing the welfare of both countries.[xi] However, this type of reciprocity does not require fully equal tariffs. Instead, countries can choose which politically-sensitive sectors they will continue to protect, which can differ across countries.[xii]

d. Effects of Tariffs on Domestic Industries, Employment, and Economic Growth

The economic effects of tariffs have been studied extensively in recent decades. When they go into effect, tariffs increase the price of their respective goods. Higher prices increase both production and employment in the protected industry.[xiii] However, the level of protection can be dampened for larger countries that affect global prices of a good. For example, consider a U.S. tariff on Mexican tomatoes. Decreased American tomato demand, and a diversion of Mexican tomatoes away from the U.S., would lower the global price for tomatoes. As a result, U.S. importers could purchase cheaper tomatoes from countries other than Mexico.[xiv]

Outside of the protected industry, the harms of tariffs can be significant. Higher prices are often passed onto domestic consumers and businesses. When placed on inputs, increased prices damage downstream manufacturers and make them vulnerable to foreign competition.[xv] Furthermore, increased tariffs invite retaliation, damaging exporters who are often already impaired by higher prices. Employment losses among exporters and downstream businesses often outweigh any gains in the protected industry. Studies have shown that tariffs have persistent negative effects on economic growth and GDP.[xvi]

III. Case Studies of Reciprocal Tariff Implementation

a. United States and China: Trade War and Tariff Escalations

In mid-2018, the U.S. Trade Representative under the first Trump administration concluded an investigation under Section 301 of the Trade Act of 1974, finding that China engaged in unfair trade practices related to technology transfer, intellectual property and innovation. In response, the Trump administration imposed tariffs on imports from China. China retaliated with its own tariffs, leading to a trade war that escalated until the Phase One Agreement was reached and signed in January 2020.

In the following years, economists attempted to quantify the trade war's effects on the American economy. Studies indicate that GDP growth slowed slightly; estimates range from 0.3-0.7%.[xvii] A 2023 study by Oxford Economics estimated that, at its peak, the trade war cost 245,000 U.S. jobs. In the stock market, the investment growth rate slowed by around 1.9%. U.S. households and firms paid for nearly all of the tariff costs, resulting in an $88 billion loss in real household incomes.[xviii] American farmers were hit particularly hard, as retaliatory tariffs nearly eliminated a $24 billion market in China. While the U.S. trade deficit with China decreased slightly, the overall trade deficit continued to grow. Rather than accede to the Trump administration's demands, China lowered tariffs for its other trading partners to keep prices from rising. As part of the Phase One Agreement, China agreed to some of Trump's demands, including a commitment to protect American intellectual property. China also committed to purchasing an additional $200 billion of American goods; in the following years, experts found that this commitment went largely unfulfilled. Economists agree that the trade war failed to boost U.S. manufacturing, employment, or growth, and did not achieve the stated goal of balancing the trade deficit.

b. USMCA vs. NAFTA: Changes in Tariff Structures and Reciprocal Enforcement

In addition to the trade war, President Trump's first term also produced the renegotiation of NAFTA into the United States-Mexico-Canada Agreement (USMCA). A significant exception to the WTO's MFN principle involves the creation of a free-trade area, in which countries allow reduced barriers not available to the rest of the world. Signed in 1992, the North American Free Trade Agreement established a free-trade zone between the three signatories. When implemented in 1994, NAFTA immediately lifted most of the existing tariffs between the three countries. Throughout his campaign and presidency, Trump criticized NAFTA, calling it "perhaps the worst trade deal ever made". Upon taking office, the Trump administration quickly began the process of working out a new deal. After months of negotiation, all three sides came to an agreement and signed USCMA in November 2018. After ratification by each nation's government, the agreement went into effect in July 2020. USMCA retained many of NAFTA's provisions and is largely a modernization of the original agreement. Key differences include strengthening rules of origin for automobiles, expanding market access for U.S. agriculture, increased intellectual property protections and new provisions on digital trade and small and medium sized enterprises.

The USMCA has been largely successful at increasing cooperation between the three signatories and promoting common interests. A more connected continent has fostered supply chain resilience and decreased reliance on unpredictable trade partners such as China. Furthermore, the agreement has promoted the development of industries important to national security, such as semiconductors, clean energy, and important minerals.[xix] Looking forward, the success of the USMCA demonstrates the benefit of negotiation with trade partners. When looking to amend outdated or unequal trade agreements, unilateral modifications often lead to retaliation, and escalation, that harms both parties. On the other hand, engaging in dialogue with trade partners can provide a solution that benefits both countries and their citizens.

IV. Economic and Political Implications

The second Trump administration has introduced a series of significant tariff measures, including tariffs on imports from China, Mexico and Canada, as well as to steel, aluminum, automobiles and a wider range of products under reciprocal tariffs.

Many economists caution that the administration's tariff plan could have adverse effects on the economy. The Tax Foundation generated estimates regarding the tariffs against China, Canada, and Mexico, as well as steel, aluminum, and autos, without considering retaliation. They project a 0.4% decrease in GDP and a reduction in hours worked equivalent to 358,000 full-time jobs.[xx]

Similarly, the Yale Budget Lab found that the 20% broad tariff the administration is reportedly considering would increase inflation by more than 2%, passing the costs onto American consumers.[xxi] Also, uncertainty regarding retaliation and potential policy reversals has made it difficult for businesses to plan for the future. This uncertainty could be further exacerbated if U.S. policy significantly disrupts the existing global trade framework.

Unilateral adjustment of tariffs, as has been practiced by the Trump administration, is against the guidelines set by the WTO. The U.S. is one of the principal members of the WTO, and abandonment of the principles and functions of the organization could encourage other nations to follow suit. When countries fail to meet the commitments they've agreed to, the WTO is designed to mediate disputes brought by affected trade partners. However, in 2019 the first Trump administration blocked appointments to the Appellate Body, a key part of the appeal process. The Biden administration maintained the freeze, and as a result the WTO has been unable to resolve disputes for several years. This has led to increased instability and protectionism, which would likely be exacerbated by a reciprocal tariff plan and subsequent retaliatory measures.

V. Conclusion

The U.S. is the largest economy in the world and has been a leader in world trade for decades. A fully reciprocal tariff schedule rejects the core principles of the world trade system and the WTO. While such a plan could open necessary discussions about fairness and modernization, it could also have substantial consequences for domestic businesses and consumers. As the administration's reciprocal trade policies become clear, businesses and consumers alike may anticipate instability in global and domestic markets.

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[i] https://www.nber.org/system/files/chapters/c13857/c13857.pdf
[ii] https://corporatefinanceinstitute.com/resources/economics/smoot-hawley-tariff-act/
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