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Article

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Intereconomics

Suggested Citation: Clausing, Kimberly A.; Obstfeld, Maurice (2024) : Letter from America: Trump's 2025 tariff threats, Intereconomics, ISSN 1613-964X, Sciendo, Warsaw, Vol. 59, Iss. 4, pp. 243-244, <https://doi.org/10.2478/ie-2024-0048>

This Version is available at:

<https://hdl.handle.net/10419/301425>

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Trump's 2025 Tariff Threats

Former US President Donald Trump's public statements on tariffs have ranged from merely alarming to evidently impossible, but one thing is clear: these tariff threats should be taken seriously. Both the candidate and his advisers have been relentlessly consistent in their repeated emphasis on raising tariffs and cutting income taxes. Trump's specific proposals include both a 10% across-the-board tariff on all trading partners as well as 60% or higher tariffs on goods from China. These tariff proposals occur alongside calls for tax cuts that would cost as much \$5 trillion over ten years. Trump has even floated the idea of completely replacing income taxes with tariffs.

Reducing the role of the federal income tax and replacing it with revenues from sky-high tariffs on imports would be deeply harmful to both the US economy and the world economy. In the United States, it would cost jobs, increase federal deficits, and generate both recessionary and inflationary pressures, risking stagflation. It would also increase the tax burden on the poor and middle class while benefitting those at the top. Abroad, this policy would antagonize US allies and partners, provoking worldwide trade wars, damaging global economic growth and undermining international collective action. It would also destabilize the global financial system.

Can Trump's tariffs replace the income tax? Simply put, no. Tariffs would be levied on a tax base comprised of US imported goods, which totaled \$3.1 trillion in 2023. The income tax is levied on a tax base that consists of incomes, which exceed \$20 trillion. The US government raises about \$2 trillion in individual and corporate income taxes at present. It is impossible for tariffs to fully replace income taxes. Tariff rates would have to be implausibly high on such a small base of imports to replace the income tax, but as tax rates rise, the base itself would shrink as imports fall. In our recent analysis,¹ we show the revenue-maximizing tariff rate is likely to generate only a fraction of the revenue needed to replace the income tax.

But tariffs could still finance significant income tax cuts. A recent Peterson Institute policy brief calculated that revenues from Trump's 10%-60% tariff proposals could total more than \$200 billion per year in current dollars, money that could be put toward income tax cuts.² Even higher tariffs could raise more revenue, perhaps as much as \$780 billion per year (from a 50% across-the-board tariff). Both figures are optimistic assessments of the revenue potential of tariffs, however, since they do not account for many important negative factors, including lower US economic growth due to retaliation, and the negative growth effects from the tariffs themselves. Such high tariffs would create big distortions in Americans' economic activity, while increasing tax avoidance, tax evasion and lobbying for exemptions.

What are the consequences of tariffs for the tax system? Tariffs are a particularly distortionary form of consumption tax. Because they only tax imports, tariffs shift production in the economy away from things it does well and toward activities in which a country has no comparative advantage. Further, even a straightforward consumption tax has important effects on the distribution of the tax burden, since poorer households save very little and consume more traded goods as a share of their income than richer households, who save far more and consume relatively few

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¹ <https://www.piie.com/blogs/realtime-economics/2024/can-trump-replace-income-taxes-tariffs>.

² <https://www.piie.com/publications/policy-briefs/2024/why-trumps-tariff-proposals-would-harm-working-americans>.

traded goods as a share of their income. In a recent policy brief, we showed that tariff burdens are therefore starkly regressive, even as they make all households worse off.³

Trump proposes not only to levy tariffs, but to use the revenue to cut income taxes. Imagine he pushes this policy to the maximum, raising \$780 billion in tariff revenue and cutting income taxes by \$780 billion, in proportion to the current income tax burdens of individuals and corporations. The dramatic distributional consequences of this fiscal shift (ignoring growth effects). The bottom 80% of the income distribution loses, with only those at the top benefiting. The pattern of regressivity is stark; the bottom quintile loses the most, nearly 9% of their after-tax income, whereas the top 1% of households gain an amount that is nearly 12% of after-tax income.

Some have argued that increased tax burdens might be worth it to workers who benefit from an industrial renaissance due to the protection of high tariffs. Yet, neither the economics nor experience supports this view. The US economy is already at full employment, so expanding production in tariffed sectors inevitably draws resources away from other sectors in the economy. Manufacturers who rely on imported intermediate inputs would face higher costs. At the same time, high tariffs would lead inevitably to forceful retaliation by US trade partners alongside massive disruptions to supply chains. As multiple studies show, the first round of Trump tariffs harmed both job growth and industrial competitiveness.

These tariff and income tax plans will have large ripple effects on the world economy: raising the equilibrium value of the US dollar, harming the outlook for global economic growth, creating inflationary pressures and harming international collaboration across many issue areas.

Consider first the effect on the dollar's exchange rate. A range of macroeconomic models predict that permanent tariffs on US imports would cause the dollar to strengthen in the foreign exchange market. With a 50% tariff, the dollar's appreciation could be massive – a substantial fraction of the huge tariff hike. The accompanying tax cuts would reinforce its effect. A rising dollar is one reason why Trump's tariffs and tax cuts are unlikely to resolve the persistent US trade deficit. Further, dollar appreciation risks financial instability in the world economy, as countries that have borrowed in dollars experience rising debt burdens and as global financial conditions tighten.⁴

Another large risk is trade wars. After the Trump Administration significantly increased tariffs on Chinese goods, China responded proportionately, reducing Chinese imports of US goods substantially.⁵ If countries throughout the world raise their own tariffs in response to Trump's new tariffs, global economic headwinds will increase as the gains from trade diminish across the world. At the same time, higher import costs will entail upward price pressure, risking stagflation.

Waves of retaliation and counter-retaliation in the trade arena will also make it more difficult for jurisdictions around the world to work together to respond to other pressing global collective action problems like climate change, public health emergencies, nuclear non-proliferation and security.

A lot is at stake in the next US election, which will have ramifications that stretch far beyond trade policy. Trump's tariff proposals would affect more than \$3 trillion in trade, nearly ten times the trade targeted by his earlier China trade war. Whereas the Biden Administration has recently announced new tariffs on Chinese goods (and kept Trump's earlier tariffs), these new tariffs affect only \$18 billion in trade, well under 1% of the volume of trade that Trump's proposals target. The Biden Administration's trade policies are more narrowly targeted at strategic aims. Trump proposes to make tariff proceeds a key component of US federal tax revenue. While the benefits of this impractical plan, if any, are unclear, its costs seem especially dangerous at this fragile moment in history.

3 <https://www.piie.com/publications/policy-briefs/2024/why-trumps-tariff-proposals-would-harm-working-americans>.

4 https://www.brookings.edu/wp-content/uploads/2022/09/BPEA-FA22_WEB_Obstfeld-Zhou.pdf.

5 <https://www.piie.com/research/trade-investment/us-china-trade-war>.