Why Tariffs Matter

Tariffs impose a cost on all products that cross a border, thus raising prices within the country that imposes the tariff. Higher prices affect supplies as farmers respond by increasing output and affect demand as consumers buy less. Countries apply tariffs primarily to protect domestic industries. This and other justifications for tariffs are discussed in the box, *Why Countries Use Tariffs*. The domestic market effects of tariffs can also spill over onto world markets as the combined effect of more supply and less demand reduces imports. If the country imposing the tariff is a large importer, then world prices can fall. Thus, the case against tariffs has two components: the distortions created within the country via higher domestic prices and the costs imposed on other countries via lost export sales and lower world prices.

Table 1 shows how tariffs affect different parts of the agricultural economy for three categories of countries: the tariff-imposing country, exporting countries, and importing countries. The effects are shown for the final consumption and the product as an input or intermediate good. For simplicity, the analysis focuses on a single commodity, durum wheat, and two final products, pasta and bread.

The country imposing the tariff in table 1 realizes a drop in net economic benefits. This loss of overall economic benefits comes from two sources. First, a higher domestic price draws resources into wheat farming, instead of other agricultural and nonagricultural uses, that might have created more value elsewhere. For example, capital and labor used to produce extra wheat might be more productive elsewhere, such as producing alternative crops or information technology. Second, higher wheat prices alter consumer choice and lower real income.

While tariffs increase prices in the imposing country, they can also lower world market prices. Producers in all other countries suffer from lower prices. Thus, while tariffs in one country may be seen as protecting its domestic wheat farmers, those same tariffs penalize wheat farmers in other countries. The high level of, and differences in, tariffs across countries shown in figure 1 indicate that current protection levels shift wealth across national borders.

The higher consumer price extends to industries that use the product, such as manufacturers that use wheat in pasta production. For example, tariffs that increase the price of wheat for domestic pasta manufacturers could decrease the price for foreign pasta makers. The higher wheat price raises costs for domestic pasta makers and puts them at a disadvantage to foreign companies in both the domestic and foreign markets.

Table 1 focuses on one commodity, but the costs and benefits from a single tariff can spill over to other commodities as well. As stated earlier, tariffs can draw resources away from the production of other commodities within a country. They can also alter production and consumption decisions in other countries. Lower international wheat prices could cause farmers in other countries to plant alternative crops such as barley or rapeseed, leading to an increase in their supply and a resulting fall in world price. By altering prices, tariffs alter economic incentives, which can significantly affect how efficiently economies use their resources. In general, one might expect that the more complex a country's tariff schedule, the less likely that any single component will have the intended effect.

To summarize, tariffs are a tool to protect domestic industries. They transfer income from consumers to producers and across the value-added chain. Tariffs have other unintended or spillover effects as well.

Table 1—Imposing/increasing a tariff on wheat has widespread effects

	Effect of wheat tariff on—		
	Country imposing tariff (higher domestic price)	Exporting countries (lower world price)	Importing countries (lower world price)
Wheat farmers	+	-	-
Processing industry (bread, pasta)	-	+	+
Consumers (bread, pasta)	-	+	+
Government tariff revenues	+	0	*[1]
Net benefits	-[2]	-	+

[1]Tariff revenues in other importing countries could fall to the extent that they apply ad valorem tariffs that raise less revenue when world prices fall.
[2]A theoretical argument shows that for the country implementing the tariff, an "optimal tariff" can increase net benefits if the tariff causes world prices to fall and allows the country to "collect" tariff revenue from producers in other countries. In practice, the pattern of existing tariffs is unlikely to meet this criteria.
Source: Economic Research Service, USDA.

First, they decrease overall wealth by distorting production and consumption. These distortions can filter down to prices of land and other inputs primarily used in agriculture. Second, tariffs in one country hurt farmers in other countries and benefit foreign consumers. Additional spillover effects across countries include changes in other countries' balance of payments through changes in export or tariff revenue and import costs.

Why Countries Use Tariffs

Providing protection against competition from imports for a specific commodity or sector is the most common reason countries apply tariffs. Underlying this reason, however, is the old mercantilist notion that a country is better off if it exports more than it imports and that, therefore, protective tariffs will add to the nation's prosperity. One of modern economics' greatest contributions has been to point out the fallacy of the mercantilist argument by demonstrating the economywide benefits from free trade.

But, the economic case against tariffs, which exposes the distribution of costs and benefits to the economy, also helps to explain why those who benefit from tariffs continue to lobby ardently for protection. The costs, in the form of higher consumer prices, are spread out over a large number of consumers. However, the benefits are concentrated on a relatively small group of producers of the product. Any change in tariffs simply means more to the average producer than to the average consumer.

Several reasons are commonly used to justify applying tariffs. In agriculture, concern about farm income as well as nonmarket benefits from agriculture (e.g., benefits from agricultural landscapes) provide rationale for farm programs that often include tariffs as a policy instrument. Tariff protection is often an integral and essential element of a country's domestic agricultural policy and can only be eliminated if accompanied by changes in domestic regimes. In particular, programs designed to raise domestic prices above world prices may be unsustainable in the face of increased imports. While providing protection to producers, tariffs also raise consumer prices and create more distortions than direct support for producers. Therefore, economists find that policies that directly target the policy objective, such as income transfers to address low incomes, are more effective policy instruments than tariffs (Corden).

Some justifications for tariffs relate to current market conditions. Temporary use of tariffs has been justified in order to protect new or infant industries and to provide a window to become established in the market. In practice, however, these tariffs prove difficult to remove, as those that benefit come to rely on the protection they provide. Under specific circumstances, tariffs can be introduced or raised even when they are bound at zero or have low rates. For example, the WTO allows members to apply anti-dumping (AD), countervailing (CVD), or special safeguard (SSG) duties (and, in the case of safeguards, import quotas). CVDs are sometimes applied to offset subsidies by other countries, while ADs are applied when foreign firms sell products below costs. SSGs can be imposed if a country experiences an increase in the volume of imports or a drop in the price of imports which exceed certain trigger levels. Tariffs applied for these three reasons represent an extremely small, but growing share of all tariffs, and WTO rules provide guidelines for their application.

Governments in developing countries sometimes apply tariffs to achieve other objectives. The relative ease of taxing goods at international borders compared to levying income or sales taxes makes tariffs an attractive source of revenue. Managing the balance of payments by restricting imports is another rationale developing countries use to apply tariffs.