Tariffs Simplified – March 2025

Tariffs are simply a levy or tax imposed on imported goods and services. Tariffs, more often applied to goods than services, would tend to increase the cost of those imported products and thereby reduce the demand for such within that country's domestic market.

There are three broad rationales for imposing tariffs: to protect local manufacturers or farmers from foreign competition, to generate government revenues, and to punish or extract concessions from another country or countries.

Of all of the policy tools available to an administration to support local industries, tariffs are probably the easiest to explain. The current U.S. Administration touts this simplicity as a rationale for a focus on tariffs. A narrative long on "unfair" foreign competition is typically used to justify raising what is effectively raising the prices on imported products (e.g., illegal home-country subsidies, dumping of excess production or lower environmental standards).

However, that simplicity in narrative, belies how complicated it is to predict or estimate a tariff's ultimate effects – for example, what portion of the tariff is borne by the foreign suppliers, by the local OEMs and the local-end buyers? Or what are the ultimate impacts on domestic markets, investment in new local productive capacity and evolving supply chain relationships?

Positive Effects of Tariffs on the Protected Country

Historically, a primary reason for imposing tariffs was to protect domestic industries from foreign competition. A fixation on trade balances were a defining feature of "mercantilist" policies, popular in the 17th and 18th centuries. In simple terms, tariffs make imported goods more expensive, improving the competitive position of local producers. If successful, this will increase the domestic industrial base, improving its competitiveness, providing the associated jobs and help build gold reserves.

This protection can be particularly important for nascent or immature industries. Significant tariff or non-tariff protection provides them the time to grow to a competitive scale, more able to compete with foreign competitors.

Tariffs can also be a source of government revenue. This is particularly true for developing nations lacking an effective income tax regime.

There are fewer historical examples of broad-based tariffs used to punish certain countries. Targeted measures such as sanctions, quotas or outright bans are usually more effective. For example, China has made extensive use of non-tariff trade barriers to both grow local industries and to selectively punish countries.

The U.S. Administrations, pretexts aside, clearly see access to their huge domestic consumer base as a benefit that should be used to extract concessions on a wide range of grievances, some unrelated to trade or industrial policy.

Negative Effects of Tariffs on the Protected Country

While tariffs will support the protected domestic industries, they may have negative consequences for the economy as a whole. Having just been through a period of adjustments, to control higher inflation, markets are sensitive to the possible inflationary impacts of tariffs. Not only will the cost of imported raw materials, components and finished goods increase, but domestic producers will likely raise prices to maintain profit margins or exploit their newly-found pricing power. Many companies used the cover of 2022/2023 inflation to increase their profit margin through above-inflation price increases. This particular effect would be inflationary and impact households on already stretched budgets.

A domestic producer that imports materials or components and exports finished products may find itself less competitive in important export markets. Additionally, small businesses may struggle to absorb the additional costs of tariffs, since they likely have fewer options to reconfigure already fragile supply chains.

Producer countries would likely respond with "retaliatory" tariffs. This would its own demand shock, and further disrupt global supply chains, reducing efficiencies. In addition, if these dynamics reduce business or consumer sentiments, businesses might delay or reduce capital investments, leading to broadly lower economic output.

Negative Effects of Tariffs on the Exporting Country

While the impact on exporting countries will almost certainly be negative, the extent of that harm is very difficult to predict. Nothing is static in trade economics. Exporters will look for new markets, importers will adjust away from products with tariffs attached, governments will adjust policies and similar broad economic impacts as described above will also impact the producer country as retaliatory tariffs are applied.

The impact will ultimately depend upon things like the absolute rate of the tariffs, the range of goods they hit, the length of time they are imposed, the options that exist to re-route supply chains or change trading partners, and the extent to which excess capacity for comparably priced goods exists in the protected country.

These complexities are highlighted by the Governor of the Bank of Canada in a recent speech during which he discussed the U.S. Administration's tariff threats, available at https://www.bankofcanada.ca/2025/02/speech-tiff-macklem-february-21-2025/

Possible adjusting mechanisms within the producer country, including fiscal or monetary policy adjustments is discussed by Letko Brosseau & Assoc. in a recent note: https://www.lba.ca/perspective/us-tariffs-on-canadian-trade/

Whether retaliatory tariffs will be effective as punishment or an inducement will depend in part on the relevant impact that trade has on each country's economy as well as the size of the trade imbalance. The United States would experience a lower economic contraction as a result of a trade war than would most of its trading partners, simply because trade represents a lower proportion of its economy.

Summary

Tariffs have both positive and negative effects on the country applying tariffs. While tariffs may protect targeted local producers, there are other effects, especially if other countries retaliate, that combine to make it difficult to predict the ultimate economic benefits.

If the purpose is to raise revenue, you don't want import volumes to decline. If you are trying to protect jobs or reshore manufacturing, then you want to essentially block imports. If you are punishing, then you want a scalpel.

The effect of tariffs on the producer country, while mostly negative, can also be difficult to predict because much depends upon post-tariff adjustments, retaliatory response and nature of the tariffs.

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