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25-19 Tariffs as Fiscal Policy

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ABSTRACT

The year 2025 brought a remarkable shift in the role of tariffs in the US economy, as the Trump administration simultaneously escalated the use of broad tariffs and ensured that Congress enacted large income tax cuts. This fiscal switch has important implications for the US tax system. While maintaining tariff rates at summer 2025 levels would generate large government revenues, such broad tariffs have significant downsides: Efficiency losses would approach one-third of revenues raised, the tax system would be less progressive, and there would be serious tax administration concerns. The fiscal shift also has significant macroeconomic implications, although probably not the intended ones. Broad tariffs generate a large negative supply shock, simultaneously raising prices and reducing macroeconomic activity.

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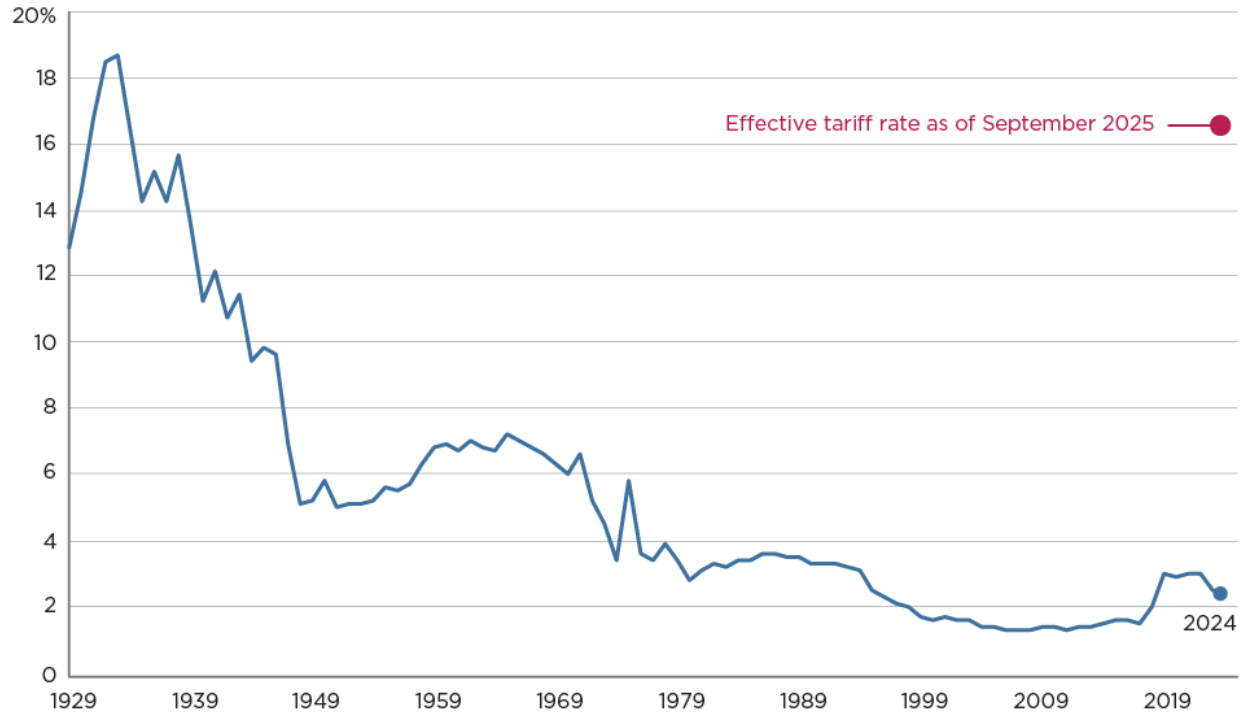
I. Introduction

With the election of Donald Trump to a second (nonconsecutive) term in November 2024, it became clear that tariffs would play a much larger role in US economic policy. Trump's first term saw a large expansion of the use of tariffs, with tariff revenues nearly doubling relative to imports, but his 2024 campaign promised a far larger role for tariffs. In the early days of 2025, the effective tariff rate soared from under 3 percent at the end of the Biden administration to over 20 percent; as of September 4, 2025 it stood at about 17.5 percent (Budget Lab 2025a), the highest level since 1935. The future of tariffs remains unclear; Congress has yet to legislate regarding tariffs, and legal challenges against many of the tariffs are underway. Nonetheless, we expect these issues to be relevant for policy discussions for some time.[1]

Figure 1 US effective tariff rates: Customs duties relative to total spending on goods imports, 1929-2025



Source: Data on customs duties and imports are from the US Bureau of Economic Analysis. The 2025 tariff rate is from Budget Lab (2025a). Actual revenues may be lower than those implied by this rate due to myriad exemptions, discussed below.

[1] The International Trade Court ruled against the administration's use of the International Economic Emergency Powers Act (IEEPA) in the context of the 2025 tariffs; that decision was appealed and affirmed by the Federal Circuit in August 2025. This case will likely reach the Supreme Court, and if upheld could trigger refunds to importers (Berger 2025). In the meantime, the existing IEEPA tariffs are being collected while the legal challenge is pending.

While tariffs have been an intriguing tool for policymakers of both parties, the recent increase in the use of US tariffs has introduced an important public debate about their place in national economic policy. We focus in this paper on defensible arguments[2] about possible roles for tariffs, considering first conventional uses of tariffs long discussed in the modern tariff literature. We then examine the present approach of using tariffs as a fiscal policy instrument.

The broad use of tariffs by the current Trump administration is novel. It marks a departure from the modern practice in rich countries, where tariffs have a very minimal scale and role; for high-income OECD countries, tariffs account for a mere 1.25 percent of the value of goods imports, and less than 2 percent of government revenues.[3] Even more noteworthy, the Trump administration's use of tariffs is part of a larger fiscal switch that moves tax burdens away from the income tax and toward import taxes (tariffs). The tariffs in place as of this writing would generate large revenues. Therefore, together with Trump's 2025 changes in tax law under the "One Big Beautiful Bill Act" (OBBBA), which not only extend the expiring tax cuts from the 2017 "Tax Cuts and Jobs Act" legislation but also enact a broad array of new income tax cuts, 2025 marks an important shift in how the US government is funded.

In this paper, we evaluate this US fiscal shift according to standard tax policy criteria, focusing on revenue, distribution, efficiency, and tax administration. As of the summer of 2025, the Trump tariffs are on track to raise substantial revenues. Still, even at revenue-maximizing rates, tariffs would generate less than one-fifth the revenue of the federal income tax, and at such high tariff rates, efficiency losses would be nearly as great as the revenue raised. Even at tariff rates of 20 percent, efficiency losses are about one-third of revenue raised.

The present fiscal switch also affects the distribution of tax burdens in the United States. The 2025 tax legislation (OBBBA) substantially cut federal income taxes in a way that was tilted toward the top; gains in after-tax income were far higher for the top quintile than for those lower in the distribution, and the bottom quintile was made worse off (Budget Lab 2025c; Congressional Budget Office 2025b). Tariffs also have a regressive impact, raising taxes more for those in the bottom quintile than for those in top quintile (Budget Lab 2025c; Clausing and Lovely 2024). In addition, today's tariff rates are particularly high, variable, and uncertain; this pattern generates serious tax administration problems, high compliance costs, negative investment effects, and large rent-seeking and corruption opportunities.

[2] In contrast, some make implausible claims about tariffs. In 2025, President Trump and various Trump administration officials often argued that tariffs are simply not a tax that burdens Americans.
[3] These figures are calculated using import data from Harvard Atlas of Economic Complexity, tariff and tax revenue data from the OECD, and World Bank categories delineating high-income countries.

Finally, we consider the macroeconomic consequences of tariffs, examining how they affect macroeconomic objectives such as employment, inflation, growth, and international accounts balances. While tariffs may be intended to generate manufacturing employment, foreign investment, and/or a reduction in US foreign trade imbalances, these goals are unlikely to be met. Instead, such broad tariffs generate a large negative supply shock, simultaneously increasing prices and reducing macroeconomic activity with ambiguous effects on the aggregate trade deficit.

II. Traditional Rationales for Tariffs

While tariffs have not played a major role in US fiscal policy for nearly a century, the use of tariffs to pursue more limited policy objectives has been relatively common, even in the post-World War II period when overall tariff rates have been quite low (see figure 1).

Tariffs as Foreign Policy

Countries often restrict trade with their adversaries; the typical pattern is a complete ban of either all trade, or trade in strategic goods. The logic of such trade bans, often taken under the rubric of economic sanctions, is straightforward. Countries voluntarily deprive themselves of the gains from trade to deprive their adversaries of the same. While these actions can be merely symbolic, they are often intended to bring about changes in behavior. The historical record, however, indicates that there are few such successes. While sanctions have often inflicted harm or inconvenience, they more rarely change behavior.[4]

One reason for the ineffectiveness of sanctions in achieving larger aims is the ease with which trade is reshuffled. When one country, even a very large one, restricts trade with an adversary, there are typically many other countries available to fill the gap. Even when there is plurilateral cooperation, it is often not sufficient to prevent the remaining countries outside the coalition from taking up the missing trade. And the broad consensus needed to develop effective multilateral sanctions is often lacking.

[4] Drezner (2024) provides a concise overview, noting that one review (Hufbauer et al. 2009) found that about a third of sanctions had achieved some success, defined as making "at least a modest contribution to a goal that was partly realized." Morgan, Syropoulos, and Yotov (2023), using data from the Global Sanctions database, find that sanctions are somewhat more successful in some time periods, reaching as high as 42 percent success rates, but success has decreased since 2016. Using the same database, Felbermayr et al. (2020) find a similar overall success rate as Hufbauer et al. (2009).

However, trade restrictions can be more effective, at times, in limiting access to key products, especially if the sanctioning country has a monopoly, or near monopoly, on the product in question. However, even in those instances, policy aims may be thwarted by workarounds or domestic adaptation.[5]

One interesting distinction relates to the difference between a trade embargo or ban and a tariff. While economists will easily recognize an embargo as a prohibitive tariff, there are important legal differences. The US Constitution gives Congress the power of the purse, including the levying of duties, and carves out only narrow exceptions for the executive branch in particular circumstances. Further, most national security-related trade matters do not lend themselves naturally to tariffs (or taxes) as a policy solution. If an adversary should not have access to a particular good, why let them buy their way out of that prohibition by paying a tariff, even if the tariff would reduce the target's welfare relative to free trade?

Of late, the argument that protectionism serves national security aims is most often made with respect to China. However, the conversation often confounds two issues: geostrategic rivalry with China, and a concern that Chinese subsidies and trade practices create an unfair advantage for Chinese firms and industries. (In the United States, both of these concerns have strong bipartisan support at present.) Still, these concerns imply different policy solutions. For example, if tariffs were used to retaliate against unfair trade practices, with the hope of eventually changing such practices, the result could easily become more, not less, trade with China as existing barriers are removed in both directions. To the extent that the problem is instead geostrategic, though, that would typically imply efforts to reduce trade, especially in strategic goods. In that instance, tariffs on nonstrategic consumer goods have little rationale.

If a country is too dependent on a country with which it has a conflictual relationship, tariffs can also be used as a tool to shift trade to more reliable partners. Some of the improved diversification may prove illusory if the underlying trade is merely diverted to other countries through transshipment, but real patterns of trade will likely also shift. Evidence from the US-China trade war of the first Trump administration shows that tariffed trade from China fell, in part due to reorienting toward other countries, but the overall reliance on trade with China remained high (see Bown 2022 and Freund et al. 2025).

A final argument within the national security realm is that tariffs may be helpful to maintain or build a competitive advantage in key industries with strategic or military importance. This

[5] For one discussion of the circumvention of Soviet era export controls, see Bown (2023). Similar issues have come up with respect to export controls on key technologies to China; see Chorzempa, Lovely, and Wan (2024) for one discussion.

argument is like those surrounding industrial policy, discussed next, with the twist being the security rationale.

Tariffs as Industrial Policy

When particular industries are deemed especially desirable, tariffs are rarely the first best solution. This is because by artificially raising a good's market price, tariffs generally combine a selective domestic production subsidy with a selective consumption tax. While there may be a policy reason to encourage domestic production, there is rarely a policy reason to discourage consumption of the same good. Thus, a subsidy (or, related, a tax exemption or cut) is a more direct policy. Still, if fiscal constraints might limit the use of subsidies, tariffs may become an (admittedly inferior) policy solution.

The industrial policy rationale for a tariff also begs the question of why the industry is special. National security provides one reason; the production of weapons or defense systems has benefits that might justify a national interest in domestic production. A second rationale is a belief that some sectors, such as manufacturing, generate positive externalities throughout the economy. A third is the "infant industry" argument. An infant industry is one that might eventually become competitive on world markets, but it may need temporary support (in its infancy) to grow and develop, either through subsidies or through tariffs.

A key question is why markets can't spot the potential of the infant industry and accordingly provide finance (either through debt or equity) for the interim period until the infant "grows up." Two answers are given. First, capital market imperfections may prevent such investments. Second, the industry (not the firm) may have economies of scale, referred to as "external" economies of scale. In this case, industrial growth drives down costs, but early entrants into the industry are not able to fully appropriate the benefits from early industrial development, which may spill over to other firms in the same industry as learning and technology progress.

In this context as well, tariffs are usually second-best (or worse) in comparison with subsidies. Not only do subsidies avoid the consumption tax element of tariffs, they also transparently subject domestic firms to the test of international competition, since domestic firms receive the same prices as foreign firms, and the amount of government support is directly observable. In contrast, a tariff provides a protected home market where inefficient firms have the illusion of being competitive in the home market, even while they fail to meet the test of world markets.

A similar comparison holds for those goods that may be associated with positive externalities (such as vaccines, or goods that promote new types of clean energy). A subsidy is more likely to

encourage both the *use* and production of the good in question, since it does not raise its domestic price. Further, if the primary aim of the production of the good is to address some externality, there is not necessarily a reason to favor *domestic* production per se. A foreign vaccine can stop disease, and foreign-produced clean energy technologies will drive emissions reductions if deployed at home.[6]

A recent hope of tariff proponents on both Left and Right is that tariffs might promote manufacturing jobs and higher wages for workers. While Stolper and Samuelson (1941) showed that trade with lower-wage countries can indeed depress domestic wages, they also showed that workers' gains from protection were more than offset by losses elsewhere in the economy, making protection an inefficient means of shifting the income distribution toward labor. In addition, the central prediction of the model concerning real wages relies on very strong assumptions that generally do not hold in practice (Davis and Mishra 2007).

Still, some hold that prior trade liberalization generated particularly adverse outcomes for American workers, so trade liberalization might usefully be reversed to remedy the situation. While some workers undeniably have suffered from trade liberalization, it is problematic to make this the fulcrum of a blanket critique of trade. First, there are strong reasons to doubt that trade was responsible for more than a minority of the job market disruptions of prior decades. Second, while some have described this problem as an "externality" that tariffs can correct—consumers of cheaper imports did not factor in the costs of their economic decisions for import-competing domestic producers—we caution that that term is misused in this context. Trade liberalization does not generate an externality in the traditional sense of the word. Externalities involve a social cost that differs from private cost, whereas adverse effects from the price effects of market outcomes (sometimes referred to as "pecuniary" externalities) are essentially reallocations: There are winners and losers but no economic inefficiency (which would imply an opportunity for Pareto improvement). For example, carbon emissions involve true externalities: Emitters harm individuals outside a market (e.g., for coal) who suffer from climate change, creating a social cost for which they do not pay. However, in the case of those dislocated by trade-based market disruption, (labor) market participants themselves are directly hurt by a reduction in demand for their skills, but those who benefit from the demand shift gain and no inefficiency is indicated.

Third, if the concern is to cushion adverse labor market impacts of economic changes, the ideal response is unlikely to be protection, which may actually harm those facing disruption for

[6] In this regard, the national content provisions in the Inflation Reduction Act (which provided myriad clean energy tax subsidies) were mistaken on economic grounds, and they raised the costs of clean energy adoption. Whether such provisions were necessary to achieve political support is a separate question.

reasons described below. While government responses to those experiencing disruption (due to *any* cause) are often still sensible, there are far better policy solutions on offer.[7]

In general, while tariffs can change the *allocation* of jobs, they do not by themselves change the number of jobs (which depends on macroeconomic considerations). Further, if the goal is to encourage the return of long-lost manufacturing jobs, one must attend to the particulars of policy design, or policies may easily backfire. For instance, a majority of US imports are intermediate goods, and broad tariffs can harm the competitiveness of US manufacturing by reducing the cost-competitiveness of the firms in the United States relative to those in foreign countries with access to tariff-free inputs.[8] Retaliation will also harm US export jobs, compounding the higher costs of imported intermediate goods for US exporters.[9] Recent research based on the 2018-19 experience supports these concerns; multiple studies show harmful effects on job creation from US tariffs.[10]

Tariffs as Remedies

An additional conventional use of tariffs in the modern era is as a remedy. For instance, a government may institute temporary tariffs to help an industry that is suffering a shock due to a large surge in imports; this is referred to as a "safeguard" use of tariffs. Countries also use anti-dumping tariffs to respond to concerns about foreign predatory pricing.[11] In addition, a government may use tariffs to retaliate for some foreign trade practices. For example, World Trade Organization (WTO) rules allow countries to respond to foreign subsidies with countervailing duties under some circumstances.

In general, there is a constructive role for tariffs in these instances. These uses deliver better results in a rules-based system that prevents the manipulation of such remedies with protectionist intent. Further, the Trump administration's recent emphasis on foreign trade

[7] Such government responses could include features such as income redistribution, a stronger safety net, wage insurance, or public investment in struggling communities. See Clausing (2019) for a full treatment of these questions.
[8] See US Census data here: https://www.census.gov/foreign-trade/statistics/historical/SAIMP.pdf.
[9] Indeed, US exporters are often big importers. See, e.g., Jensen (2016). Within a general equilibrium macroeconomic simulation model, McKibbin, Hogan, and Noland (2024) show that US industrial output and employment shrink under a variety of policy scenarios involving tariffs.
[10] See Flaaen and Pierce (2024), Russ (2019), Russ and Cox (2020a, 2020b), Autor et al. (2024), and Handley, Kamel, and Monarch (2025).
[11] In practice, anti-dumping laws are frequently exploited by firms with protectionist intent. See chapter 5 of Irwin (2020).

practices is far too broad and conceptually problematic to fall under this rubric; these issues are discussed elsewhere and will not be considered further here due to space constraints.[12]

The "Optimal" Tariff

Finally, there is a textbook argument for why tariffs might be beneficial for a country that is immune from retaliation, since their large size may allow them to manipulate the terms of trade in their favor, benefiting national (at the expense of global) welfare. This argument only holds in certain cases. Large countries may have the ability to drive down the relative prices of their imports on world markets through a tariff-induced increase in supply of the import good and reduction in its demand.

The classical analysis of the "optimal" tariff assumes perfect competition. Under imperfect competition, however, a tariff may induce foreign suppliers to compress their profit margins, transferring rents to the home economy; see Helpman and Krugman (1989). In either case, the potential benefit from a tariff depends on its ability to push down import prices, thereby enhancing the importing country's terms of trade.[13]

There are three important caveats that apply to the US situation. First, this argument assumes that foreign countries are not large and do not retaliate. In practice, in the past, large economies such as China and the European Union have retaliated with tariffs of their own on US goods, and this can undo favorable terms of trade advantages, simply driving down the gains from trade without any side benefit (Johnson 1953). In fact, the potential for this dynamic was part of the inspiration for a rules-based trading system under GATT/WTO, since countries could "tie themselves to the mast" in a manner that avoided this adverse outcome.

Second, there is the question of how large a country needs to be to affect world prices. The United States accounted for about 13 percent of world merchandise good imports in 2023 (UNCTAD 2025). While that is a sizable fraction of world demand, shifts in US supply and demand may be insufficient to generate large changes in world prices, especially if either US import demand is particularly inelastic (as we might expect for some goods where the United States lacks a comparative advantage) or when world supply is highly elastic. Of course, in some markets the United States may have a larger (or smaller) role than the 13 percent average. Moreover, imperfect goods arbitrage between national markets allows suppliers of

[12] Discussions of the problems behind Trump's so-called "reciprocal" tariffs include Irwin (2025), Clausing (2025), and Obstfeld (2025a).

[13] In settings with differentiated goods and imperfect competition, tariffs could also reduce the variety of goods available to consumers, a negative factor for domestic welfare.

differentiated goods to price to market, tailoring prices to national demand conditions (for example, Chen and Juvenal 2022). As the world's single biggest importer, the United States could potentially induce some suppliers to lower their US profit margins via tariffs.

Third, however, an extensive body of high-quality empirical evidence from the first round of Trump tariffs found unambiguously that US buyers of imports paid the full cost of the China tariffs.[14] Whether the Chinese case is *sui generis* and applies to the case of far broader tariffs remains to be seen; new studies from the experience with Trump's 2025 tariffs should help shed light on that question in the time ahead.

III. Tariffs as Tax Policy

Tariffs as a Revenue Source

Prior to the advent of the income tax in 1913, customs duties accounted for 49 percent of US federal revenue (Hungerford 2006). With the passage that year of the US Constitution's 16th Amendment unambiguously allowing income taxation, the United States moved away from a primary reliance on tariffs in favor of the income tax and (later) payroll tax. Turning back the clock, the Trump administration now seeks to restore tariff revenue as a centerpiece of US fiscal policy. President Trump has mused about entirely replacing the income tax with tariffs, while Commerce Secretary Howard Lutnick has floated the more modest but still ambitious goal of eliminating income tax on annual incomes below $150,000.

How much revenue could tariffs raise? As always, the difficulty is that taxes on an activity (in this case, trade) discourage it, limiting the revenue that can be raised. This gives rise to a "tariff Laffer curve" according to which revenue rises with the tariff rate until tariffs reach a critical level beyond which further hikes *lower* revenue.

At the same time, as we detail in the following subsections, tariffs have a range of costs, which must be reckoned against the revenues they might yield to assess their net efficacy as a mode of taxation.

Simple trade models can give a rough idea of the tariff and revenue levels at which the Laffer curve peaks. As a first step that is robust across models, observe that a country's aggregate demand for imported products, C_M, is a function of (i) the money price of imports inclusive of an ad valorem tariff τ, $(1+\tau)P_M$; (ii) the overall money price level, P; and (iii) the level of total nominal domestic spending, Z,

[14] See Clausing and Lovely (2024) for a review of those studies, which include Amiti, Redding, and Weinstein (2019), Cavallo et al. (2021), Fajgelbaum et al. (2020a, 2020b), Fajgelbaum and Khandelwal (2022), Flaaen, Hortaçsu, and Tintelnot (2020), and Houde and Wang (2023).

$$C_M = M[(1+\tau)P_M, P, Z], \qquad (1)$$

with partial derivatives of sign $M_1 < 0, M_2$ ambiguous, and $M_3 > 0$.[15]

With this specification, tariff revenue is $R = \tau P_M M$ and the partial effect of the tariff on revenue (i.e., holding all other import determinants constant) is

$$\frac{\partial R}{\partial \tau} = P_M M + \tau P_M^2 M_1.$$

Let $\eta < -1$ denote the partial elasticity of import demand with respect to tariff-inclusive import prices. Then tariff revenue is maximized where $\partial R/\partial \tau = 0$, or equivalently, where

$$1 + \left(\frac{\tau}{1+\tau}\right)\eta = 0 \Leftrightarrow \tau = -\frac{1}{1+\eta} \qquad (2)$$

(Johnson 1951; Tower 1973; Irwin 1998). There is a tariff Laffer curve, with tariff revenue declining as tariffs are raised further beyond the revenue-maximizing rate in (2).

Two different trade models illustrate the determinants of the import elasticity η and implications for tariff revenue. For the moment we assume that the world price of imports and the home price of domestic goods expressed in terms of domestic currency are given, ignoring terms of trade effects. We will explore alternative assumptions about the behavior of nominal spending, *Z*.

A first framework is the workhorse Armington (1969) model with a constant elasticity of substitution (CES) σ between import and domestic-goods consumption, C_M and C_D. In computing the import price elasticity η, we include the effect of the tariff in raising the general price level *P*, given a constant price of domestic goods and a constant world price of imports.[16] However, we derive different elasticities depending on whether nominal spending *Z* in equation (1) is assumed to be constant (implying declining real incomes due to the tariff, which raises the price level) or to rise in proportion to *P* (keeping real incomes, *Z*/*P,* constant). The second case might reflect compensation of importers with rebated tariff revenue and implies a muted

[15] The general price level P depends on $(1+\tau)P_M$ and the price of domestic goods, P_D, and it is sometimes convenient to express import demand in terms of $(1+\tau)P_M$ and P_D rather than P_M and P.

[16] In this model, the representative household's utility function is $\left[\alpha^{\frac{1}{\sigma}} C_M^{\frac{\sigma-1}{\sigma}} + (1-\alpha)^{\frac{1}{\sigma}} C_D^{\frac{\sigma-1}{\sigma}}\right]^{\frac{\sigma}{\sigma-1}}$ and the demand for imports is $C_M = \alpha(P_M/P)^{-\sigma}(Z/P)$, where $Z = P_M C_M + P_D C_D$ and $P = [\alpha P_M^{1-\sigma} + (1-\alpha)P_D^{1-\sigma}]^{\frac{1}{1-\sigma}}$ is the exact consumer price index (Obstfeld and Rogoff 1996). More broadly, the model can also be construed as encompassing firms' imports of intermediate products.

import elasticity. Let s_M denote the share of import spending in total spending.[17] In this CES case,

$$\eta = \begin{cases} -\sigma(1 - s_M) - s_M & (Z \text{ constant}) \\ -\sigma(1 - s_M) & \left(\frac{Z}{P} \text{constant}\right) \end{cases}.$$

A second framework is based on homothetic translog preferences, as in models of Bergin and Feenstra (2001), Rodríguez-López (2011), Feenstra and Weinstein (2017), and Novy (2013). In this case,

$$\eta = \begin{cases} -\frac{\gamma}{s_M} - 1 & (Z \text{ constant}) \\ -\frac{\gamma}{s_M} - (1 - s_M) & \left(\frac{Z}{P} \text{constant}\right) \end{cases},$$

where γ is a preference parameter describing the sensitivity of relative import demand to prices.[18] The translog specification has the property (shared with a linear demand function for imports) that the absolute value import price elasticity becomes very large as the import share declines, implying that higher tariffs quickly become prohibitive (whereas for CES, $\eta \to \sigma$ as $s_M \to 0$).

Parameterizing the two models for the United States shows their predictions for how the tariff rate affects tariff revenue. We assume that tariffs are levied on $3.3 trillion in goods imports, the US figure for 2024, and assume that the starting share of imported goods in spending is the US figure for 2024, which was 11 percent and reflected a trade-weighted average tariff rate of 2.4 percent.[19] For σ in the CES model we assume a value of 3, whereas for γ we take the US point estimate of 0.19 reported by Feenstra and Weinstein (2017).[20]

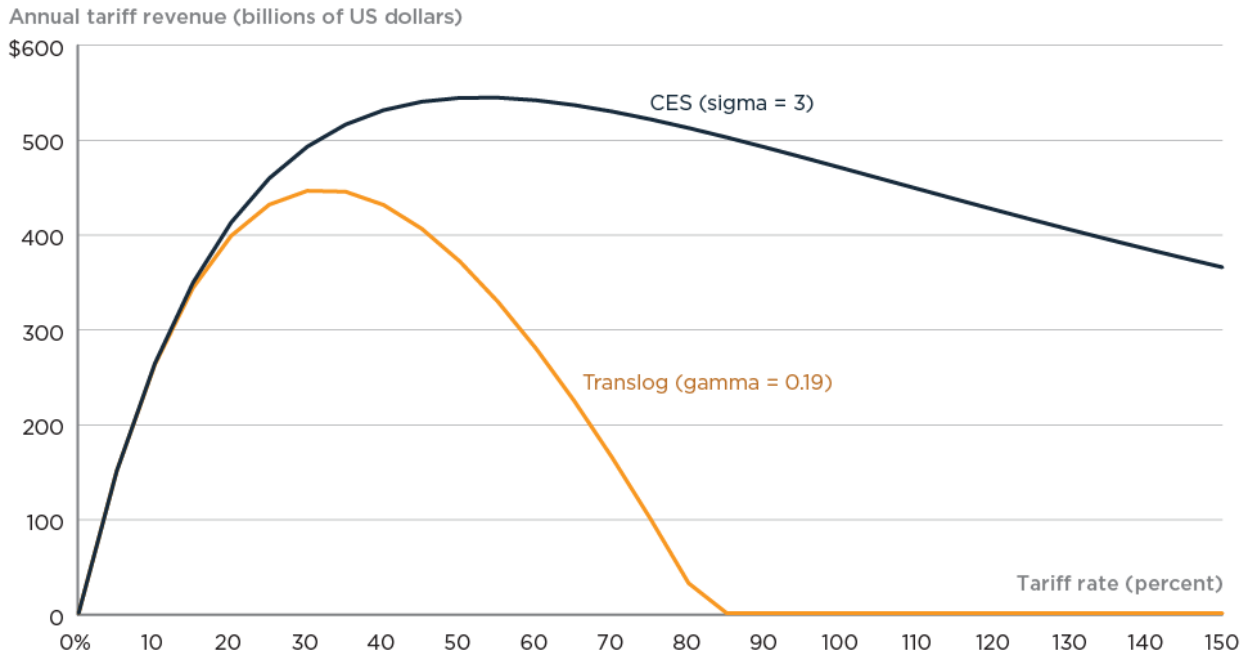
Based on the 2024 US import share of $s_M = 0.11$ and, for example, looking at the constant Z case, the import demand elasticities for that year were $\eta = -2.781$ for the CES model and $\eta = -2.735$ for the translog model. For these elasticities, if we mechanically apply equation (2) to find the revenue-maximizing tariffs, these are 56.1 and 57.6 percent, respectively. The calculation is misleading, however, because at a tariff of 56 percent, s_M would be lower and η

[17] For CES preferences, $s_M = \alpha(P_M/P)^{1-\sigma}$.
[18] The translog import demand function is $C_M = [\alpha - \gamma \ln (P_M/P_D)](Z/P_M)$, from which s_M follows as $P_M C_M/Z$. When this demand is negative, we interpret it as meaning that $C_M = 0$.
[19] US GDP in 2024 was $29.2 trillion, and with a goods and services trade deficit of 3.1 percent of GDP that year, total spending (absorption) was (1.03) × ($29.2 trillion) = $30.1 trillion. US goods imports in 2024 were $3.3 trillion, equal to 11 percent of spending.
[20] Ossa (2016) reports a median trade elasticity of 3 across product categories for global data. Obstfeld and Rogoff (2005) assumed $\sigma = 2$, which is consistent with the US estimates that Feenstra et al. (2018) report. Estimates typically reported in the trade literature have been larger, as Obstfeld and Rogoff (2005) and Arkolakis, Costinot, and Rodríguez-Clare (2012) discuss.

higher in both preference setups. To find the globally revenue-maximizing tariff, we need to apply both equation (2) and the equation determining the endogenous variable s_M, which depends on τ.

Figure 2 shows the tariff Laffer curves for the two models in the constant *Z* case, allowing s_M to vary with tariff. In the CES model with $\sigma = 3$, tariff revenue peaks at $544 billion per year at a tariff rate of 53 percent. (This is roughly the maximizing rate found by Clausing and Obstfeld 2024). For the CES specification, the import price elasticity is rather insensitive to the import spending share s_M, and the globally revenue-maximizing tariff is not far below the one resulting from applying equation (2) to 2024 data. Were $\sigma = 2$, implying a much less price-elastic import demand, maximum revenue would be just under $900 billion at a tariff rate of about 105 percent. However, a tariff rate half as large (the maximizing rate for $\sigma = 3$) would still yield close to $800 billion.[21]

Figure 2 Tariff revenue Laffer curves for the CES and translog import demand models



CES = constant elasticity of substitution
Source: Authors' calculations.

In the translog specification, tariff revenue tops out at $447 billion at a tariff rate of only 32 percent. Revenue drops off very quickly for higher tariff rates, with imports and revenue

[21] The CES revenue numbers are based on applying the tariff rate to the free-on-board value of imports, $P_M M = \frac{s_M Z}{1+\tau}$ where $s_M = \frac{s_{M,0}(1+\tau)^{1-\sigma}}{s_{M,0}(1+\tau)^{1-\sigma}+(1-s_{M,0})}$ and $s_{M,0}$ and Z are 2024 values (see footnote 19).

dropping to zero well before a 100 percent tariff rate is reached. Here, η rises quickly as the import share in spending, s_M, falls, and the latter falls quickly as the tariff rises. In this translog case, it would therefore be very misleading to judge the revenue-maximizing tariff from the 2024 import share.[22] The translog specification may be extreme in predicting how rapidly trade disappears, but the implications of a constant import price elasticity for high tariff rates seem implausible, as Irwin (1998) also observes. For example, the CES model implies that at an overall tariff rate of 300 percent, the US government could still collect $180 billion in tariff revenue.

The models used to generate figure 2 can give rough orders of magnitude. For example, at a tariff rate of 20 percent, about 2.5 percentage points above tariff rates as of September 4, 2025, both functional forms imply tariff revenue of about $400 billion per year, implying about $300 billion in revenue after accounting for the mechanical revenue offset, as is standard practice in tax estimates for excise taxes (CBO 2022).[23] These estimates do not fully incorporate the dynamic economic effects of tariffs because the import demand equation (1) depends not just on tariffs but on the essentially macroeconomic variables P_M, P, and Z.[24]

These estimates leave aside the possibility that the US can exercise some monopoly power in trade. If so, the before-tariff prices US importers pay fall because of US tariffs. The endogenous response of world prices to tariffs lowers the responsiveness of imports to tariffs because the fall in price to some degree counteracts the negative effect of the tariff on import demand. Consequently, the potential revenue yield of tariffs is higher. As noted earlier, the extent to which the United States can move world prices is unclear and likely varies across goods. J.P. Morgan (2025) guesses that on average, 80 percent of current tariff hikes will pass through to the prices that US consumers and businesses pay. In this case, for the parameters in figure 2, maximum yearly tariff revenue is about $640 billion (or $480 billion post offset) in the CES case and $540 billion ($400 billion post offset) in the translog case—both figures about $100 billion above the maximums when world import prices are constant. At a tariff rate of 20 percent, annual tariff revenue is about 7 percent higher in the presence of market power, relative to the baseline case.

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[22] The curve is generated as $R = \frac{[0.1095 - .19 * \ln((1+\tau)/1.0242))]Z}{(1+\tau)}$ with Z at its 2024 value. The formula above for the revenue-maximizing tariff implies it equals s_M/γ in this case.

[23] Tariffed dollars cannot be taxed elsewhere in the system, which implies reducing net revenues accordingly through an offset. As the Congressional Budget Office (CBO) states: "The value of the offset varies each year…but in recent years has generally ranged from 21 percent to 25 percent of estimated revenues from indirect taxes; therefore, the net revenues generated from an indirect tax are only about three-quarters of the gross amount of revenues collected from the tax."

[24] Import prices depend on a range of factors including exchange rates, monopoly power in trade of the United States and foreign suppliers of imports, trade invoicing practices, and global demand. The US price level responds to those factors and others, and it can evolve independently of US aggregate demand *Z* (for example, owing to supply shocks, which tariffs can cause).

We leave a more detailed explanation of macroeconomic effects of tariffs until the last section of this paper but note that broad universal tariffs are contractionary (e.g., McKibbin, Hogan, and Noland 2024) and therefore lower tariff revenues over relevant budgetary planning horizons. Table 1 summarizes a variety of revenue estimates, many of which show a "dynamic score" that accounts for negative effects of tariffs on economic activity. These numbers are typically lower than those we derived. This is true even before accounting for the effects of foreign retaliation, which would lower US revenue even more.

Table 1 Recent estimates of tariff revenues

Estimate source	Time period	Tariff assumptions	Aggregate revenue (billions of dollars, rounded)
Budget Lab 2025a	2026-2035	Dynamic score, tariffs as of September 4, 2025; 17.4 percent effective tariff rate	2,000
Penn Wharton Budget Model 2025	2025-2034	Dynamic score, tariffs as of April 8, 2025; 22.5%* effective tariff rate	4,500
Tax Policy Center 2025	2025-2035	Dynamic score, tariffs as of April 2, 2025, 22.5%* effective tariff rate	3,500
Congressional Budget Office 2025a	2025-2035	Static score, tariffs as of August 19, 2025, about 20.5% effective tariff rate[25]	3,300
Clausing and Lovely 2024	2026-2035	Static score, 10% incremental universal tariff and 50% incremental tariff on China	2,800
York and Durante 2025	2025-2034	Dynamic score, 20% incremental universal tariff	2,600
McKibbin and Shuetrim 2025	2025-2034	Dynamic score, 20% incremental universal tariff with retaliation	800

Note: Asterisk indicates effective tariff rates were not provided in the study but taken from the closest Budget Lab analyses, as those were updated with each major announcement. Note that CBO uses an 11-year window, which will mechanically increase their revenue numbers relative to other scores, particularly those ending in 2034.

[25] Congressional Budget Office 2025. "An Update About CBO's Projections of the Budgetary Effects of Tariffs." Estimates are a static score of all tariffs in effect as of August 19, 2025. CBO reports that tariff rates have increased by more than 18 percentage points, but they do not report the base level, which is assumed here to be about 2.5 percent.

Noncompliance can affect revenue yields from tariff rates. Pomerleau and York (2025) assume a 15 percent noncompliance rate, and Budget Lab assumes a 10 percent noncompliance rate. Further, exemptions and exceptions can reduce the level of tariffed imports. Donnan et al. (2025) report that through July 31, 2025, at least $1.15 trillion of US goods imports (on an annualized basis) were escaping tariffs through carve-outs for products, firms, industries, and imports subject to free trade agreements. The last category could expand as, for example, companies previously content to suffer the low US-Canada tariff on goods not compliant with the United States-Mexico-Canada Agreement invest to bring them into compliance.

Of note, even the astonishingly high tariff rates that would maximize tariff revenues would generate insufficient revenues fully to replace the income tax. In fiscal year 2025 (as of August), Treasury data indicate that the personal income tax generated $2.4 trillion in revenue, that the corporate income tax generated about $400 billion in revenue, and that payroll taxes (on labor income) generated $1.6 trillion in revenue (US Department of the Treasury 2025a). In comparison, tariff revenues would hit their maximum at about $370 billion per year (after offset, averaging the two Laffer peaks from figure 2). This is less than one-sixth the level of personal income taxes.

Efficiency

While most taxes entail distortions, a few are less bothersome for efficiency purposes: A head tax, while distributionally problematic, does not distort behavior. Pigouvian taxes, such as carbon taxes or sin taxes, can even improve efficiency, since left to their own, markets will otherwise oversupply the goods in question since markets do not factor in the negative social effects from, for example, excess emissions. Finally, a pure profits tax can result in the sharing of economic rents with the government without distorting underlying profit-maximizing input or output decisions by firms (Stiglitz 2015; Clausing 2024).

In contrast, most tax instruments generate efficiency losses, or deadweight losses, because they distort socially desirable activities such as labor and saving. For example, an income tax will reduce labor transacted in the market as some workers would supply more labor before-tax than they would after-tax. At present, the US government relies mostly on labor income taxes, with about 75 percent of federal revenues coming from taxes on labor income, with the remainder coming from taxing capital income, rents, and a few other items (through fees and excise taxes, which may ultimately be borne in part by labor).[26]

[26] In fiscal year 2024, the payroll tax (on labor income) accounted for 35 percent of federal tax revenues, and the income tax accounted for 49 percent of federal tax revenues; Treasury data indicate that labor income is about 80 percent of nontransfer income.

From an efficiency perspective, the use of tariffs might be most relevantly compared to income taxation, especially if (as is currently the case in the United States) the stated policy intention is to shrink the income tax while expanding the use of tariffs. Consumption taxes are in some ways similar to *labor* income taxes, since both exempt savings from taxation.[27] Since consumption taxes have distortions similar to those due to labor taxes, moving from one to the other is not that consequential. However, tariffs are particularly distortionary forms of consumption taxes. By only taxing *some* (imported) consumption, tariffs misallocate resources, expanding the sectors where imports are tariffed (the import-competing sectors) and contracting other sectors (export and nontraded sectors). Since this reallocation is counter to a country's natural comparative advantage, it reduces the gains from trade. Gains from trade generally arise where the marginal opportunity cost of foreign production is lower than that of domestic production; by reducing trade, tariffs sacrifice those efficiencies.

There are also significant inefficiencies generated from tariffing production inputs, and such tariffs generate *negative* protection for final goods industries, which compete with peer firms abroad that are not facing costlier inputs (Corden 1971). This is not a trivial issue, due to the broad use of tariffs and the fact (already noted) that a little more than half of US imports are intermediate goods. As one example, steel and aluminum tariffs have been common in the United States, even before the latest 50 percent tariffs on metals, and such tariffs have cost many more jobs in steel-using industries than they created in the steel industry (Russ and Cox 2020a). Further, the biggest US exporters are often big US importers (Jensen 2016), so intermediate goods' tariffs directly harm US exporters (even beyond industrial reallocation effects).

Finally, tariff retaliation by trading partners (who may impose their own tariffs on US export goods as retaliation for higher US tariffs) can shrink US export markets, compounding these inefficiencies. As noted above, many studies of the first Trump administration tariffs concluded that they were, on net, harmful for job creation; see footnote 10.

For ballpark estimates of the deadweight efficiency losses associated with different tariff levels, we can return to the model that generated the preceding tariff-revenue Laffer curves. We carry out this exercise for the CES model; welfare losses for the translog model are likely to be of a similar order of magnitude (Arkolakis et al. 2019). In a simple context where trade is limited by tariffs, Costinot and Rodríguez-Clare (2014, p. 227) show how to calculate the deadweight national welfare loss due to raising US tariffs from their 2024 level, accounting for the federal

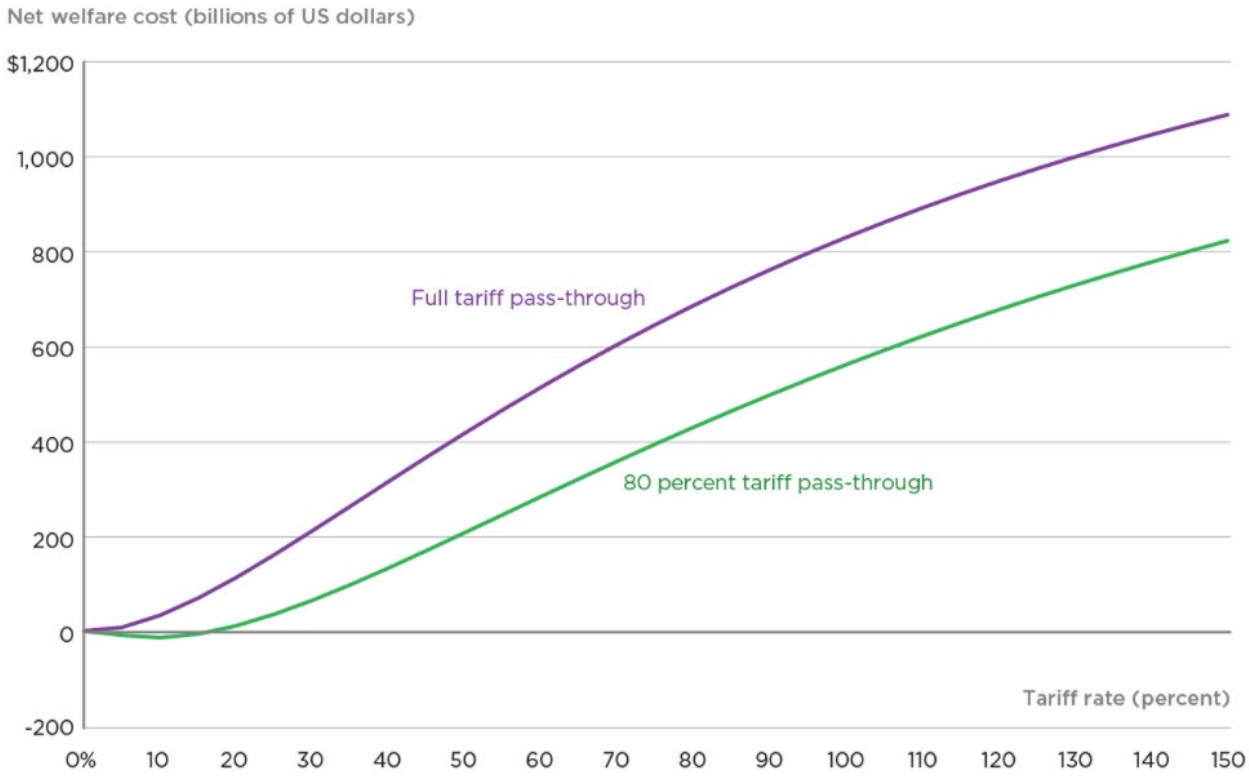
[27] While exempting savings is seen by some as desirable, in practice such exemption can also allow rents to escape taxation until rent income is consumed (which may be quite some time in the future); this consideration will bear on the distributional effects of tariffs discussed below.

government's gain in revenue at the expense of the private sector. If we use a prime ($'$) to designate post-tariff levels, then the ratio of post- to pre-tariff hike real national income is given by the sufficient statistic

$$\left(\frac{1-R/Z}{1-R'/Z}\right)\left(\frac{1-s'_M}{1-s_M}\right)^{-1/\varepsilon}, \qquad (3)$$

where $\epsilon = \sigma - 1$ is the "elasticity of trade," R is tariff revenue, and s_M is the import share of spending. According to this formula, a fall in the import share of spending due to higher tariffs lowers real income, but this can be to some degree offset by higher government tariff revenue.

Figure 3 Net welfare cost of raising US tariffs from 2024 levels



Source: Authors' calculations.

Assume first that the tariff passes through fully to import prices. The upper line in figure 3 shows the added deadweight loss when $\sigma = 3$ due to raising the tariff rate from its 2024 average effective value of about 2.5 percent. Some benchmark values illustrate the costs of tariffs as a means of raising revenue. At a tariff rate of 20 percent, for example, the pure efficiency cost of raising an extra $329 billion (about $250 billion after offset) in revenue (that is, the $412 billion total the model implies less the approximately $83 billion that was collected in 2024) is $113 billion (calculated as a percentage of 2024 US GDP, which was $29.18 trillion).

That is, even ignoring offsetting effects on overall tax system revenues, more than a third of the additional revenue raised is offset by social losses due to forgone gains from trade.

Another way to think about the tariff effects is as a loss per household, assuming households bear all the burden of paying the 20 percent tariff. With about 132 million US households in 2024, the average household would bear additional costs of $2,492 in tariff payments ($329 billion/132 million) and $856 ($113 billion/132 million) in additional deadweight loss, for a total of $3,348 per household per year. At a tariff rate of 50 percent, about the revenue maximizing rate above, additional tariff payments would be $461 billion ($544 billion – $83 billion) and additional deadweight loss would be $419 billion, or 91 percent of the revenue raised, implying a total extra per-household cost of $6,667 annually, again ignoring offsets.

Of note, the efficiency loss per dollar of tariff revenue raised is convex in the tariff rate, with efficiency losses rising more than proportionately as tariffs increase. The elasticity of trade is also crucial. The higher the elasticity, the larger the ratio of welfare loss to revenue at any tariff rate. While these insights are familiar to public finance experts, since they parallel well-known optimal tax theory findings, they also have implications for today's policy context. For instance, as tariff rates settle at predictable levels and as firms and consumers adjust over time to the new tariff regime, we expect trade elasticities to rise (Ruhl 2008), with associated increases in efficiency losses relative to revenue.

The efficiency calculation here is oversimplified since it does not account for the fact that many US imports are intermediate goods. However, as Costinot and Rodríguez-Clare (2014) show, adding intermediate goods could raise the deadweight costs of tariffs sharply.[28] We have also ignored that current US tariffs vary across trade partners, amplifying efficiency costs as discussed below.

A further potential complication is that the United States might shift the terms of trade in its favor, as suggested by the concept of the "optimal" tariff that would seek to maximize net tariff gains. Equation (3) also applies in this case. The lower line in figure 3 shows the net additional welfare costs of different tariff rates relative to the 2024 level when $\sigma = 3$ and assuming again an 80 percent pass-through of tariffs to import prices. The tariff rate that maximizes US welfare is 9.5 percent, far below the level as of this writing of about 17.5 percent.[29] At this "optimal"

[28] Another factor potentially raising welfare costs relative to our simple model is heterogeneity among importers (Ossa 2015). Those with low demand elasticities can dominate the effective ϵ that enters the preceding calculation of forgone trade gains because the latter depends on the reciprocals of individual elasticities. However, this may not make a big difference for tariff revenues if the low-elasticity firms have relatively small import shares.

[29] Ignatenko et al. (2025) find a somewhat higher "optimal" tariff, in part due to different trade elasticity assumptions. However, they caution that tariffs remain inefficient from a global standpoint and that unilateral

tariff, the net gain to the United States (relative to US 2024 output) is $14 billion, which is only 0.05 percent of 2024 GDP. However, even beyond acknowledging the paltry welfare gains from pursuing such terms-of-trade benefits, these calculations do not factor in negative macroeconomic implications, foreign retaliation, or costs of the collateral tariff distortions (associated with compliance, avoidance, lobbying, and the like) that we describe below; these considerations would likely eliminate any benefit from pursuing so-called "optimal" tariffs.

A value-added tax (VAT) would be far less distortionary than a tariff, and even a small VAT could raise similar amounts of revenue as Trump's current tariff plans. As of mid-June, tariffs were forecast to raise about $2 trillion over a ten-year budget window (see table 1 above, Budget Lab 2025a). An analysis showing Joint Committee on Taxation estimates indicates that even a narrow-base VAT at a mere 5 percent would raise over $2 trillion over the budget window (2025-34); a broad-based 5 percent VAT would raise well over $3 trillion.

Distribution

As with efficiency, tariffs might usefully be compared with income taxes in their distributional impact. Table 2 compares existing US federal taxes in terms of the share of total tax payments from different segments of the income distribution. The poorest decile pays a smaller share of most taxes than their share of total income, indicating that most federal taxes are progressive; the two exceptions are the payroll tax (which is proportional to income for this group) and excise and customs taxes, which more heavily burden this group.

Table 2 Shares of total income and tax payments for top, middle, and bottom deciles

	Bottom decile	**Middle decile (average of 5th/6th)**	**Top decile**
Income share	**0.7**	**5.7**	**44.5**
All federal taxes	-0.1	3.4	60.3
Individual income tax	-0.8	1.0	79.7
Corporate income tax	0.2	2.3	73.1
Payroll tax	0.7	6.8	32.8
Excise and customs taxes	1.7	5.4	44.9
Estate tax	0	0	94.6

Source: Cronin (2022, table 6).

deployment of "optimal" tariffs can harm the prospects for welfare-enhancing trade cooperation, risking damage to the world economy.

The progressivity of the federal tax system is also shown by the top decile, which pays a share of federal income taxes that exceeds their income share for most taxes; the exceptions are again the payroll tax (where the share is less than proportional due to the earnings cap), and excise and customs taxes (where the burden is proportional).

The prior literature has consistently emphasized that tariffs are regressive taxes, although there are differences in data, method, and mechanisms investigated; one overview is Meng, Russ, and Singh (2023). The intuition regarding why a tariff is more regressive than the income tax originates from three basic mechanisms. First, and most important, people lower in the income distribution save less than those that are better off, so consumption taxes burden them more heavily. Consumer expenditure survey data, for example, show that consumption is a steadily failing share of income as income increases. Other sources of consumption data, including Cronin (2022, table 7), show a similar pattern. Saving rates rise especially steeply at the top of the distribution, where the top 1 percent save at a rate that far exceeds the top quintile as a whole.[30]

Second, some studies indicate that poorer households consume more traded goods as a fraction of their consumption bundles (e.g., Fajgelbaum and Khandelwal 2016), although others (e.g., Borusyak and Jaravel 2021), find a pattern where traded goods comprise a roughly flat fraction of consumption across the income distribution. However, since consumption still falls with income, tariffs remain regressive even if traded goods are a flat share of consumption.

Third, the pattern of protection may heighten regressivity if tariff rates are higher on those goods consumed by poorer households. Acosta and Cox (2024) and Gresser (2002) find some evidence of that pattern in the past. In the United States, tariff rates as of this writing are both far higher and constantly changing. While this could be an important factor, it is not yet well-measured. Some early evidence on the pattern of new protection across goods suggests that some basic consumer goods (like apparel and footwear) are particularly hard hit by recent tariffs (Budget Lab 2025a, figure 8), but the situation is still evolving.[31]

[30] See Dynan, Skinner, and Zeldes (2004). Piketty, Saez, and Zucman (2016) show an even more concentrated savings pattern using more recent data, and Mian, Straub, and Sufi (2020) document a steep surge in savings among the top 1 percent in recent years.

[31] An additional factor could arise if poorer consumers have less flexibility in changing their consumption bundles in response to tariff-induced price increases, or if they are more likely to lose product variety. Focusing on these mechanisms, Ma et al. (2025) find that US tariffs on China during the first Trump administration accounted for about a 1 percent increase in households' price index, but that the increase in the price index for the highest income group was 0.9 percentage points lower than it was for the lowest income group.

There is a robust tax distribution practice at the Joint Tax Committee, at Treasury, and at outside think tanks such as the Tax Policy Center, Budget Lab, and Penn Wharton Budget Model. Within these communities, there are two main methods for accounting for the distributional effects of excise taxes and customs duties. The more intuitive approach is the "pass forward" method. Prices rise due to the tariffs, and then those price impacts affect consumers directly. One estimates who is consuming the products in question, determining incidence effects accordingly.

A related issue is the incidence of tariffs on inputs. In practice, input costs directly affect final goods prices, so one need not make elaborate incidence distinctions, as there is no reason to think that firms would bear a greater share of these tariffs than final goods' tariffs. In each case, firms could decide to cut into margins and leave prices unchanged, which would indeed affect incidence. However, many firms are too competitive to absorb large tariffs for a significant period of time without passing higher costs into consumer prices.[32] Another issue concerns lifecycle effects.[33]

An alternative method of tariff incidence analysis is to "pass-back" the effects of tariffs onto factor incomes. This method, sometimes preferred by official scorekeepers due to modeling constraints, holds prices fixed, but instead models tariffs as reducing the real incomes of sources of income that are not saved, thus falling on both labor and rent income.

While a price increase is a lot like a real income decrease in theory, in practice these two approaches to incidence often yield different results for excise taxes, with such taxes appearing more regressive under a pass-forward method than a pass-back method, since rent incomes are more concentrated at the top of the distribution than consumption (which is concentrated similarly to labor income).

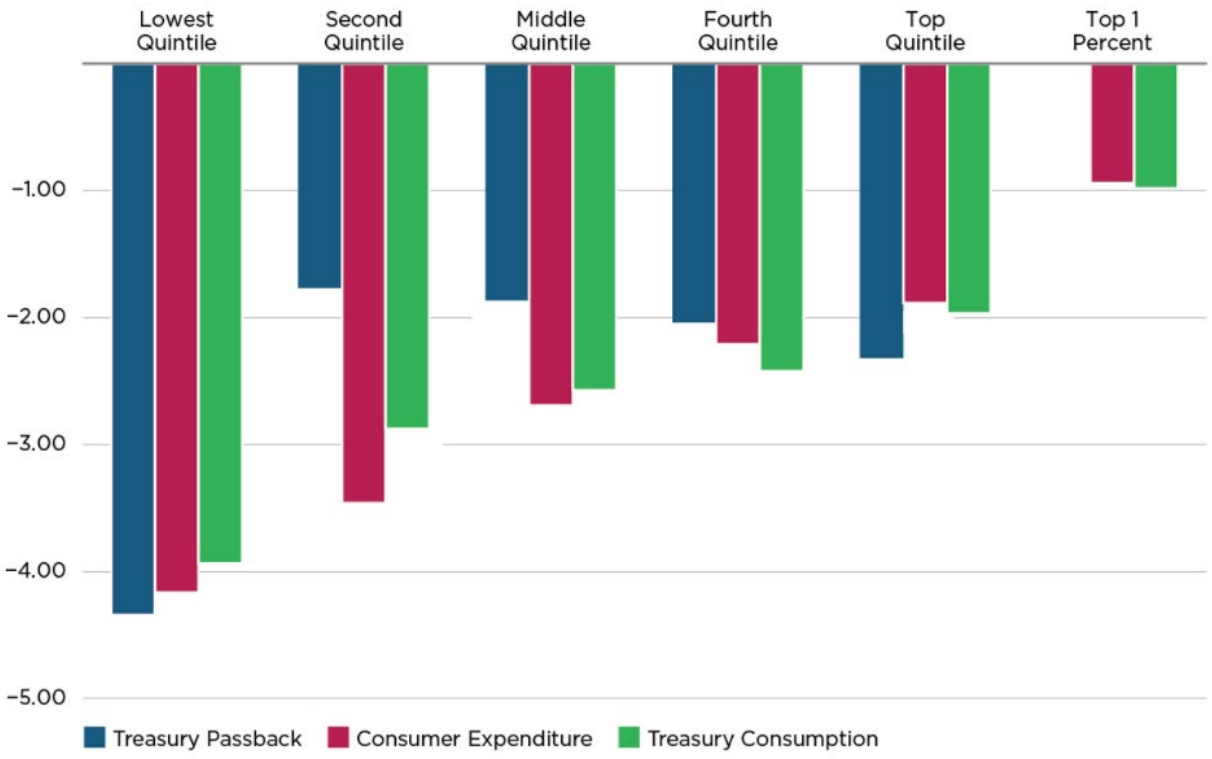
Clausing and Lovely (2024, appendix) discuss these methods, finding that tariffs are regressive taxes under both methods, but that they are more regressive under a pass-forward method

[32] The corporate tax base is very concentrated, with fewer than one-half of one percent of firms paying about 90 percent of the corporate tax (Clausing 2024). In comparison, more than 99 percent of firms earn relatively little profit. For the least competitive firms, there is more room to absorb tariffs into their prices.

[33] In the short run, tariffs affect those that are consuming today, which may be the simplest and most effective way to model them, especially if tariffs are swiftly reversed. But tariffs could also burden stocks of wealth if those that hold stocks of wealth eventually consume them by purchasing tariffed products. Penn-Wharton Budget Model (2025) reports a novel distributional analysis of the tariffs that allows readers to toggle their own assumptions regarding what share of the tariff is born by consumers relative to firms, in addition to incorporating lifecycle effects that depend on the age of the taxpayer.

than a pass-back method.[34] Figure 4 shows a distributional analysis of the Trump campaign tariff proposals, including incremental tariffs of 10 (50) percent on the rest of the world (China). The columns compare distribution based on Treasury estimates of regressivity of customs/excise taxes (using a pass-back method), a pass-forward method based on consumer expenditure data, and a pass-forward method using consumer Treasury's consumption distribution from Cronin (2022).

Figure 4 The regressivity of the Trump campaign tariff proposal under three methods, percent change in after-tax income



Source: Clausing and Lovely (2024).

Tax Policy Center (2024) reports a distributional analysis of the same Trump campaign tariff proposals, finding a nearly flat impact, with the exception of the top of the income distribution, where the burden falls somewhat. They base their distribution on incomes, allowing an exemption for the normal return to savings, and adjusting for the relative consumption of taxed and untaxed goods; the method is similar to a pass-back method.

[34] Tax increases under either method will be sensitive to the extent of exchange rate adjustment and terms of trade effects. If foreign producers lower their prices (a possibility discussed above) or if dollar strengthening is a substantial offsetting factor, those factors will dampen the tax increase associated with tariffs, although they will not change the relative regressivity of tariffs relative to income taxes.

The Budget Lab has done myriad analyses of the ever-evolving Trump tariff proposals, originally finding distributional patterns very similar to those in Clausing and Lovely (2024), using a very similar method. In June 2025 (Budget Lab 2025b), they revised their method to account for additional factors in a manner that lowers tariff burden for the 2nd, 3rd, and 4th deciles. This method accounts for the indexation of government benefits such as social security and food benefits, which helps insulate some poorer households from tariff shocks, reducing regressivity. They also incorporate the distributional effects of the tariff offset, which especially lowers the tariff burden for the top decile, adding an additional regressive consideration at the top of the distribution.[35]

Beyond the direct tax impact, there are also possible consequences for US taxpayers in their role as producers (discussed above). However, there is little reason to think that tariffs will have a large compressing effect on the pre-tax income distribution, as they are likely to increase labor market disruption and economic shocks, as resources are reallocated between the export sector, the import-competing sector, and the nontraded goods sector.

Finally, there may be geographic inequities. Some states and localities are much more reliant on trade (Rodríguez-Clare, Ulate, and Vasquez 2025), either because they include major ports of entry, or because of their industrial specialization. As one example, the state of Washington has many important export-oriented firms, including Boeing, Microsoft, and agricultural producers. Other states such as New Mexico or Oklahoma may be far less trade-dependent in their industrial composition.

Tax Administration, Compliance, and Political Economy

No tax system is costless to administer; estimates indicate that the US federal income tax generates large compliance and administration costs (Benzarti 2020; Slemrod 2019), and myriad new provisions continue to add complexity and increase administrative costs. In comparison, the payroll tax has very low compliance and administration costs, in part because it does not attempt to adjust tax burdens for individual taxpayer circumstances; wage-earners all pay the same rate up to the payroll income cap ($176,100 in 2025). Most countries also rely

[35] These adjustments would apply under either a pass-forward or a pass-back method. Since tariff dollars are not taxed elsewhere in the system, they reduce other taxes by about 25 percent of the tariff increase, thus reducing a more progressive source of revenue. Also under either method, transfer incomes such as social security are adjusted upward to account for price increases (or in the pass-back method, incomes do not decline since real purchasing power is held constant), a factor that reduces regressivity.

on VATs, which are relatively simple to administer, although they do present some challenges (Brockmeyer et al. 2024).

To some extent, tariffs are simple to enforce. Goods cross the border at known ports of entry, and a levy can be assessed in a straightforward fashion. This administrative simplicity is why tariffs were relied on before the twentieth century and remain important today in many low-income countries with limited tax capacity. However, the underlying rate and pattern of protection will influence the difficulties associated with customs administration. For instance, at present, the United States is attempting to enforce tariffs that vary by country, by product, and by share of US content, often in bewildering ways that even experts and government officials have difficulty clarifying. One timeline of trade actions in 2025 illustrates myriad reversals, exceptions, and caveats; through the end of August 2025, there were 87 major developments affecting US trade and tariff policy (Bown 2025).

The complexity of Trump's second term tariff agenda has created large compliance burdens, not just to track new developments, but to handle complicated interactions. For example, the recent Trump steel and aluminum tariffs also apply to downstream goods with embedded steel and aluminum. One calculation suggests that this increases the coverage of metals tariffs more than fivefold relative to 2018 duties while generating new complications for firms, which are obliged to report the weight, value, and origin of tariffed inputs in the goods they import (Colvin 2025). Such costs are especially burdensome for smaller enterprises. Many new tariff changes are still anticipated, including in the pharmaceutical sector.

Such high and variable tariff rates create ample opportunities for tax avoidance and evasion. Tax evasion occurs when tariffs that are legally due are not paid due to noncompliance. This could involve relabeling, transshipment (without a meaningful transformation of the product), or smuggling. US customs are sufficiently rigorous that smuggling is unlikely to be a major component of tariff evasion, but transshipment and relabeling may be more important; preliminary analysis supports that possibility although it can be difficult to distinguish transshipment from legal responses (Brooks 2025; Iyoha et al. 2025).

In contrast, a legal form of tax avoidance is to simply reshuffle trade. For example, if the US has higher tariffs on Brazil (50 percent as of summer 2025) than Ethiopia (10 percent) and both export coffee to the United States, Ethiopia might export more to the United States while Brazil might divert its trade to the markets that Ethiopia formerly served. Such reshuffling would be a natural response to highly variable tariffs across countries. One purpose of the most-favored nation (MFN) principle underlying the WTO is to avoid such distorting trade diversions.

In addition, if small packages are exempt from tariffs (through de minimis rules that exempt low-value shipments from tariffs), goods ordinarily sold through importers may instead be sold straight to consumers and small businesses. In recent years, this generated workarounds for Chinese tariffs, whereby goods would be sold directly to purchasers in smaller bundles rather than through an importer, legally avoiding the tariff. As a consequence, the number of de minimis shipments into the United States surged, with the growth in such shipments over 2013-22 (470 percent) far exceeding the overall growth in imports over the same period (14 percent); see Casey (2025).

However, in May 2025, the Trump administration ended de minimis treatment of imports from China (and the autonomous customs region of Hong Kong), and at the end of July (effective August 29), ended de minimis treatment for all goods. Further, the recently passed tax legislation of 2025 (OBBBA) would end de minimis treatment for all packages in June 2027, even if the recent executive order is rescinded or legally challenged. It is presently unclear whether US customs officials have enough resources to inspect and tariff so many small packages; recent changes would put even more packages under customs scrutiny.

Finally, in the presence of high tariffs, many importers will request exemptions. During the first Trump administration, exemption requests from the China tariffs were large (Hufbauer and Lu 2019; DeBarros 2025); such requests are likely to multiply in the second Trump administration. Political economy concerns regarding exemptions are also serious. For example, Fotak et al. (2023) found that during the first Trump administration, those that donated to the Trump campaign were more likely to receive exemptions from the tariffs, while those who donated to the opposition were less likely to receive tariff exemptions. The second Trump administration may create this dynamic on a much larger scale, due to the much higher tariff levels as well as the lower level of institutional guard rails. Krueger (1974) is a classic analysis of the additional welfare costs of competitive rent-seeking in the presence of tariffs and other trade restrictions.

More generally, tariffs that are so differentiated by country of origin, product category, and exemption possibilities are rife with corruption opportunities, not just by rewarding favored domestic businesses with exemptions (or lack thereof), but also by the setting of tariffs themselves, which makes both businesses and foreign governments alike beholden to the whims and preferences of a mercurial administration.[36] Related, there are issues associated

[36] The July 2025 Trump administration letter to Brazil, in which a 50 percent tariff was threatened in response to the Bolsonaro prosecution, is one stark example of this phenomenon. US demands for political, military, and business concessions, including commitments of hundreds of billions of dollars in flexible investment funding, have emerged as a systematic and integral part of the Trump administration's country-by-country negotiations over so-called "reciprocal tariffs" after April 2025; see Lynch and Natanson (2025). Such an approach opens more

with the current process of levying tariffs, a process that generates high tariff variability across products, origins, and time, and also a great deal of uncertainty. Typically, tax policies are legislated by Congress, and taxpayers can then read the exact parameters of the law (and subsequent regulations) to establish their tax treatment. Here tariffs are instead being levied by fiat. This raises both uncertainty and legal questions (as the courts may continue to find that many of the second term Trump tariffs exceed presidential authority) as well as concerns regarding tax administration and fairness.[37]

Retaliation

Most domestic tax policy does not generate foreign retaliation, for good reason. When foreign governments set tax policy parameters, they do so based on their own national interest, and that sovereign choice tends to be respected abroad. Indeed, the current Trump administration's attempts to use tariffs as a cudgel for many factors (including foreign governments' domestic tax policy choices) may be the exception that proves the rule; Clausing (2025) discusses why this weaponization of tariffs is inappropriate.

However, unlike domestic taxes, tariffs often beget retaliation; such retaliation may even be consistent with WTO rules, which generally allow countries to retaliate when other countries violate prior commitments. (Although often the retaliation occurs outside of WTO processes.)

During the first Trump administration, retaliation against US tariff actions by China was generally proportionate, and a similar pattern has emerged in the second Trump administration, where in response to US tariff escalation to 145 percent, bilateral Chinese tariffs rose as high as 125 percent against US exports in April 2025; these extremely high tariffs lasted about a month. During the first Trump administration, other jurisdictions beyond China enacting retaliatory tariffs included the European Union, Mexico, the United Kingdom, Turkey, Canada, India, and Russia. In 2025, both China and Canada have retaliated, but most other threatened retaliations have been paused during trade negotiations, including those by the European Union, Colombia, Mexico, and Brazil.

Further, there may be fiscal costs associated with retaliation, as the government may choose to compensate struggling exporters for lost market access due to the trade war. Indeed, in the first Trump administration, large compensation was paid to US farmers, at magnitudes that at

possibilities for rent-seeking and makes US tariffs inherently unpredictable as they become discretionary tools of international coercion.

[37] For example, consider two importers who bought a good from China in May 2025; they could easily pay vastly different tariff rates, as on some days the tariff was 145 percent, and then later the tariffs fell to 30 percent. That creates important issues of horizontal equity (treating like taxpayers similarly).

times rivaled incoming tariff revenues (Steil and Della Rocca 2020). While the scale of bailouts required to make US exporters whole in the current moment may prove staggering, especially in today's fiscal context, it may still prove tempting to bail out politically important firms.

Finally, such retaliation generates economic harm both at home and abroad, risking stagflationary pressures in the world economy due to simultaneous negative output shocks and upward price pressures everywhere. Export firms are subject to a triple squeeze because (1) resources are pulled out of the sector due to tariffs (and the possibility of currency appreciation); (2) exporters tend to be big importers of intermediate products and thus face cost increases due to tariffs on inputs; and (3) retaliation reduces market access abroad. Thus, as multiple studies for the United States have confirmed (see footnote 10), tariffs generate significant negative effects on job creation and economic growth.

IV. Tariffs and the Macroeconomy

Tariffs often focus on individual industries—for example, autos, steel, copper, or aluminum. The effects of such tariffs on the protected industry are well understood: as prices rise in the tariffed sectors, domestic input use, production, wages, and profits rise; and imports of the protected good fall. President Trump's broad-based tariffs, which apply to all countries and nearly all goods, have broadly analogous goals, but at the aggregate level: to expand manufacturing employment; to raise US output, wages, and productivity; and to shrink the overall US trade deficit. Because Trump's universal tariffs are a major macroeconomic shock, however, general-equilibrium effects can confound a naïve extrapolation from industry-level effects to the national level. To suppose otherwise is to succumb to a classic fallacy of composition.

Tariffs, the Exchange Rate, Overall Activity, and the Trade Balance

Perhaps the most common misconception about a general tariff's effects on overall economic activity stems from a naïve reading of the national income and product identity, $Y = C + I + G + X - M$, which links GDP, *Y,* consumption, *C,* investment, *I*, government sending, *G*, exports, *X*, and imports, *M*. A tariff, it is rightly observed, lowers imports, *M*. But this point leads many to the erroneous conclusion that the tariff necessarily raises the trade balance, $X - M$, GDP, and employment (Obstfeld 2024). However, although a tariff that protects an individual industry will lead to its expansion, a broad-based tariff sets off general-equilibrium adjustments that leave the impact on aggregate output and employment in question.

Tariffs have historically been debated and sometimes deployed in the hope of raising overall domestic activity. However, if there is not persistent unemployment, changes in the exchange rate will typically undo much or all of the excess demand for domestic products created by the tariff through currency appreciation (Eichengreen 2019; Obstfeld 2025b). Currency appreciation makes imports cheaper, to some degree offsetting the negative tariff effect on import demand, but at the same time it makes exports more expensive for foreign buyers. Thus, the tariff effectively taxes exports at the same time as it taxes imports, and there is no assurance that the trade balance will improve or that GDP will rise. These effects contrast with those of currency devaluation, which can raise the trade balance because it is equivalent to an import tax coupled with an export *subsidy* (Farhi, Gopinath, and Itskhoki 2014). The welfare implications are more nuanced: devaluation can have favorable macroeconomic effects (reducing unemployment) precisely because it worsens the terms of trade, whereas a tariff may improve the terms of trade (Dornbusch 1987).

During the US tariff turmoil of the first half of 2025, the US dollar broadly depreciated, rather than strengthening. This seeming departure from the theoretical prediction reflects the on-again, off-again nature of President Trump's tariff threats as well as fears of foreign retaliation and a US economic slowdown due to a volatile policy environment. Moreover, financial account transactions dominate the determination of exchange rates, and concerns about other US policies—including presidential attacks on the Federal Reserve, large legislated increases in federal budget deficit trajectories, and other institutional erosion—motivated global dollar sales during the trade war. Aggregative econometric studies that control for macro variables suggest that tariff shocks typically lead to appreciation as well as to lower output and little change in trade balances (Ostry, Lloyd, and Corsetti 2025; Furceri et al. 2020, 2021).

Several additional factors contribute to negative tariff effects on output and employment. As discussed above, industry-level studies of the 2018-19 US tariffs show that tariffs on intermediate products like steel and aluminum harmed manufacturing employment. The harmful effects from tariffing input goods scale up to the aggregate level and deter aggregate investment. Uncertainty over trade policy depresses aggregate demand, notably by deterring investment (Caldara et al. 2020).

By raising consumer prices, tariffs also compress real incomes and consumption, especially since they disproportionately harm less prosperous households with lower saving rates. As Dornbusch (1987) emphasized, the disposition of the government's tariff revenues also matters. Raising tariffs and using the proceeds for debt reduction amounts to a fiscal contraction. If revenues instead are rebated to the public, this can partially offset the tariff's negative real income effects—partially owing to deadweight efficiency losses—but only if

revenues are rebated back to income groups in proportion to tariff-induced losses. In contrast, using tariff revenues to finance regressive cuts in other taxes is contractionary. Indeed, the net impact of the OBBBA legislation and today's tariffs is likely to leave 80 percent of the population with lower after-tax incomes (Budget Lab 2025c), although the time profile of the OBBBA tax and spending changes will limit the contractionary impact in the first few years.

Contrary to the intentions of the US administration, tariffs are most likely to improve the US trade balance significantly if they compress consumption and investment enough to cause a sharp economic contraction. The factors discussed above could depress GDP, even if the trade balance improves, by reducing total aggregate demand—along with demand for imports.

Tariffs, Manufacturing, and Foreign Investment

A prime motivation for the Trump administration's tariffs is the belief that higher tariffs will substantially raise manufacturing employment. Manufacturing is valorized based on claims that it is a uniquely potent source of high-paying middle-skill jobs, an essential anchor for stable "heartland" communities, and an unmatched source of innovation. Many tariff proponents argue that US manufacturing has been hollowed out primarily because of US trade deficits, and that the use of tariffs can eliminate trade deficits, restore the manufacturing sector, and undo past damages from globalization. Some point to the American experience of industrialization behind high tariff walls in the late nineteenth century, suggesting that this can be replicated today.[38]

However, the United States was a primarily agrarian economy then, with rapid productivity growth in agriculture releasing a ready supply of labor for industry (as well as for the growing service sector). That source of labor supply was long gone by the end of World War II. Over the postwar period, there has been a steady decline in the employment share of manufacturing as workers have moved to the service sector, where productivity growth (until recently) has fallen short of the rate in manufacturing. As Lawrence (2024) documents, this has been the pattern across economies, including China, regardless of whether they have had trade deficits or surpluses, and nowhere has the pattern gone into reverse.

One problem for using tariffs to restore manufacturing is the Lerner symmetry theorem (Lerner 1936; Costinot and Werning 2019). In Lerner's framework, an import tariff is equivalent to an export tax. If a country at full employment uses tariffs to produce more of the goods it

[38] Scholars such as Irwin (2001) have questioned the causal role of tariffs in nineteenth-century US growth.

previously imported, the labor required to produce them will come out of the export sector, with no clear impact on manufacturing employment or the trade deficit.

But couldn't the necessary labor come out of the service sector? This is more difficult than it seems. Because services are predominantly nontradable—they cannot be imported and therefore must be supplied domestically—the service sector can't shrink unless domestic consumption and business demand for services fall. Thus, given the economy's resources, total manufacturing employment can expand only if the economy's total spending ($C + I + G$), which includes spending on services, falls relative to its total output (Y), resulting in higher net exports ($X - M$) and a lower relative price and supply of services. In other words, tariffs must lead to lower trade deficits or bigger surpluses if they are to spur manufacturing. But there is slim evidence that tariffs have materially affected trade imbalances, which are largely driven by macroeconomic phenomena such as government budget deficits (Obstfeld 2025b).

Finally, there is the possibility that foreign investment could make a difference in resolving such tradeoffs by adding to the US capital stock. While it is a goal of the US administration to induce a wave of foreign investment over a higher US tariff wall, the tariff also generates natural forces tending to drive foreign investors away, possibly including some foreign firms currently producing in the United States. After tariffs go up, imperfectly competitive foreign exporters earning rents from their US sales may find that they can still earn excess profits, albeit lower than before, from producing in the United States. If those profits exceed what they can now earn by producing abroad and exporting to the United States, they may choose to establish US production facilities. They will be deterred, however, by the higher prices for intermediate products due to tariffs as well as by ongoing uncertainty over tariff policy, as investments involve considerable sunk costs that can be recouped only over very long horizons. Further, there are additional deterrents in the present US case, including the possibility of labor shortages, unwelcoming policies toward foreign visitors, workers, and students, and possible concerns about US institutional weakness.[39]

Tariffs and Inflation

As a tax on imports, tariffs will raise their price. How much they raise import prices depends on the slope of the import supply function. The "optimal" tariff framework suggests that small countries are price-takers in world markets, whereas larger countries can influence world prices, allowing some of the tariff burden to fall on foreigners. As noted above, however,

[39] While some of the purported trade deals being negotiated between the US government and foreign counterparts have included investment commitments, in many cases the commitments may be merely symbolic as there are incentives to overpromise, and foreign firms are often beyond the control of the government.

evidence from the 2018-19 US tariffs on China suggest virtually complete pass-through of the tariffs into domestic prices.[40] While permanent broad-based tariffs such as Trump's are *terra incognita* in recent economic history, most economic models and studies suggest that US households and firms will bear the bulk of the tariff burden.

In one recent analysis, Minton and Somale (2025) conclude from an event-study approach that the 2018-19 tariffs and the February-March 2025 US tariffs had significant positive effects on consumer prices. Using detailed high-frequency retail pricing data classified by product and country of origin, Cavallo, Llamas, and Vazquez (2025) show that from early March through early September 2025, new US tariffs had a noticeable effect on US consumer prices, especially relative to pre-tariff trends, although there has been far less than 100 percent tariff pass-though so far.[41] Notably, the prices of domestic goods substitutable for tariffs also rose, while there is little evidence that foreign exporters to the United States have cut pre-tariff prices. Budget Lab (2025d) find that 61 to 80 percent of 2025 tariffs were passed through to consumer core goods prices, consistent with other studies of tariff pass-through. Hufbauer and Zhang (2025), using more aggregate data, suggest that US importing businesses may be absorbing significant tariff losses.

In principle, tariffs should lead to one-time upward movements in the price level rather than persistent inflation. Even for final goods, however, prices are somewhat sticky and lags in price adjustment can spread price-level shocks over time, generating higher inflation over some period. The effects can be amplified and drawn out even further for tariffs on intermediate products. In one recent study, Cuba-Borda et al. (2025) study empirically and theoretically how shocks to trade costs—including, but not limited, to tariffs—affect CPI inflation. In their empirical analysis, for example, they find that a 10 percentage point increase in trade costs relative to those of trade partners (holding fixed any global effects) raises inflation by 0.65 percentage points in the first year if it applies to final goods, and by 0.58 percentage points if it applies to intermediate goods, but with greater persistence. GDP also falls considerably. In their model, a key mechanism driving the amplitude and persistence of price responses to cost shocks is the propagation of prices through production networks. They conclude that shocks to input prices trigger relatively more persistent inflation.

The overall inflationary impact of tariffs also depends on the reaction of monetary policy, with a more accommodative stance leading to a higher and more persistent inflation impact. The

[40] Recall footnote 14.

[41] US importing businesses may be absorbing some of the tariff increases. This strategy could be due to tariff uncertainty, previous inventory buildups, or hesitancy to alienate customers with rapid price hikes. However, any importer reluctance to raise prices in line with costs is likely to dissipate over time, especially as domestic competitors raise their prices.

exchange rate response is also relevant. If the currency appreciates when a tariff is imposed, the resulting currency appreciation can dampen the effect on domestic import prices and inflation. For the United States, however, this mechanism may be less helpful in dampening price rises over the medium term, even ignoring recent dollar depreciation, because most US imports are invoiced in US dollars and their often sticky dollar prices adjust only slowly to shocks (Gopinath and Rigobon 2008).

Financial Inflow Taxes

The US balance of merchandise trade was last positive in 1975. For those who view this fact as evidence that the international economic order has disadvantaged the United States unfairly, there are two primary (but not mutually exclusive) diagnoses of the underlying problem.[42] The first is that the US deficit results from exploitative foreign trade and currency practices, in which case protective tariffs could be seen as a remedy. However, for reasons discussed above, the effect of tariffs on the trade deficit is ambiguous.[43]

The second diagnosis explaining high US trade deficits is the strong foreign demand for US assets, which generates international capital inflows that, according to balance of payments principles, must equal the current account deficit.[44] These inflows swell the trade deficit through higher US asset values (which promote consumption and investment), lower US interest rates (which work the same way), and a stronger dollar (which cheapens imports and makes exports less competitive abroad). Some, such as Pettis (2025), have therefore advocated a tax on capital inflows to reduce the US trade deficit, a proposal that was codified in legislation proposed in 2019 by Senators Josh Hawley and Tammy Baldwin. The idea may be gaining broader traction: for example, Wolf (2025) recently weighed in to support such a tax.[45]

[42] See Obstfeld (2025b) for further discussion and references.
[43] The effect is unclear for tariffs in the current range. Sufficiently high tariffs could choke off imports entirely.
[44] The current account balance includes several items beyond the trade balance, most importantly net international investment income. See Krugman, Obstfeld, and Melitz (2022, chapter 13) for a discussion of these balance of payments principles. The current account balance must equal the financial account balance (domestic net purchases of foreign assets less foreign net purchases of domestic assets), since when a country imports more than it exports, it must give foreigners claims on its assets in exchange; when a country exports more than it imports, it accumulates such claims.
[45] See their Competitive Dollar for Jobs and Prosperity Act. It would be equivalent in principle to levy the tax on either the buyers or the issuers of financial claims on the United States, although the two approaches might differ in administrative ease (and political messaging). From the standpoint of tax administration, the global proliferation of dollar stablecoins that the Trump administration is promoting may make it hard or impossible to determine whether money flows into legacy US financial markets originate abroad. Tellingly, a major use case for stablecoins to date is evasion of capital controls in emerging markets.

Unlike import tariffs, a tax on capital inflows would indeed discourage them and necessarily reduce the external deficit. Such a tax would raise interest rates and depress asset prices, raising saving and compressing investment. Importantly, even though the tax would apply only to funds borrowed from abroad, foreigners would remain the marginal lenders to the United States and therefore interest rates would rise throughout the economy, just as an import tariff raises not just import prices but the prices of domestic goods substitutable for imports. The tax would harm economic growth and the primacy of the US as a financial center, which is one source of US comparative advantage in tradable financial services.[46] While Pettis (2025) contends that a tax on capital inflows would have benign effects, his argument is contingent on the idea that US investment would be unaffected, which is certainly incorrect.[47]

A capital inflow tax would place a significant burden on the financial sector. US gross sales of assets to foreign residents are on the order of at least $5 trillion *per month* (Obstfeld 2022, figure 6). A 1 percent tax on this base could therefore bring in $600 billion in revenue a year, a prospective cost to the financial sector that would lead to a sharp and likely distorting compression of cross-border financial activity. Many argue that there are fragilities in the US and global financial systems (for example Financial Stability Board 2025), but it is unclear how a US tax on capital inflows would address them.

At present, the accumulation of prior US borrowing (the flip side of US trade deficits) has resulted in a substantially negative US net international investment position (NIIP), −82 percent of GDP at the end of the first quarter of 2025.[48] While a sufficiently large borrower may in theory be able to shift the intertemporal terms of trade in its favor through a borrowing tax (that is, force down global real interest rates), domestic borrowers would still pay a higher overall interest rate, inclusive of the tax, with attendant negative effects on the economy.

[46] The alarm that greeted the so-called "revenge tax" on foreign profits contained in section 899 of the House 2025 budget bill is perhaps a foretaste of how markets would react to a broad tax on capital inflows. The revenge tax would have levied a high tax on incoming foreign investment from many sources abroad, triggered by elements of their domestic tax regimes, including the use of digital services taxes as well as backstop provisions for the "Pillar 2" global minimum tax on multinational corporate income.

[47] To be sure, some firms may have ample cash to self-finance, but not all do, and the investment plans of the constrained firms are obviously sensitive to higher interest rates. Moreover, even firms that can self-finance their investments could see advantage in cutting investment at higher interest rates. The opportunity cost of investment would rise after a capital inflow tax, lowering the present discounted value of any stream of future investment returns while making it more profitable to place excess cash in the bond market.

[48] According to the Bureau of Economic Analysis (BEA), the US NIIP at the end of 2025 Q1 was –$24.61 trillion (https://www.bea.gov/news/2025/us-international-investment-position-1st-quarter-2025-and-annual-update) and US GDP that quarter (third estimate) was $29.96 trillion (BEA via FRED, https://fred.stlouisfed.org/series/GDP). Bayoumi and Gagnon (2025) argue persuasively that this official BEA number is inaccurate, and that the true NIIP is closer to −65 percent. But even that negative net foreign position is sizable.

The possibility of enhancing global borrowing terms is analogous to the "optimal" tariff of trade theory.[49] However, there are other ways a capital inflow tax would reduce America's debt burden to foreigners. Because the US borrows in dollars but lends extensively in foreign currencies, a capital inflow tax that substantially weakened the US dollar could transfer trillions from foreign creditors to the United States. However, US attempts systematically to exploit this channel would weaken the US dollar's international status and raise the risk premium on dollar borrowing, negating any "optimal tariff" benefit from lower pre-tax interest rates. The depressing effects of a capital inflow tax on US stock and bond prices would likewise improve the US NIIP, but with collateral domestic costs.

In general, for the United States, a capital inflow tax would inflict damage beyond any theoretical benefits. Nonetheless, the proposal may gain political traction as the Trump tariffs fail to shrink the US trade deficit in the face of higher fiscal deficits.

V. Concluding Thoughts

The year 2025 marks an important pivot in US federal tax policy. The 2025 tax and budget legislation sharply reduced expected US income tax revenues, by extending temporary 2017 tax cuts permanently and by enacting a new wave of temporary tax cuts that Congress will find tempting to extend in 2029. At the same time, a dramatic increase in the use of tariffs has caused tariff revenues to surge, reaching about $30 billion per month by August 2025, $23 billion of which is new revenue relative to August 2024 (US Department of the Treasury 2025b). If such broad tariffs survive legal challenges, tariffs could net about $2 trillion in revenue over the coming ten-year budget window. While projected US tariff revenues are insufficient to pay for the recent tax legislation, they do mark an important source of government revenue that may prove hard for future US administrations to forgo. However, even at revenue-maximizing rates, tariff revenues would be only a fraction of current US federal income tax revenue.

On conventional tax policy grounds, the US fiscal shift from income taxation to tariffs is difficult to defend. Tariffs are a particularly inefficient source of tax revenues that will destroy some of the gains from trade; the efficiency loss from tariffs at summer 2025 levels is about a third of their revenue yield, and that calculation does not include the additional costs associated with rent-seeking behavior. Tariffs are also a far more regressive tax than the income tax. In general,

[49] As an international borrower, the United States can be viewed as an importer of present consumption (when it spends beyond its means today) and an exporter of future consumption (when it repays foreign debts in the future). A capital inflow tax is a tariff on today's imports. See Obstfeld and Rogoff (1996, pp. 42-45) and Costinot, Lorenzoni, and Werning (2014).

tariffs fall more heavily on poorer households than on the well-off, for the simple reason that poorer households save very little of their income in comparison with richer households. Finally, the current implementation of US tariff policy suggests additional costs beyond those that are well-documented in the literature. The new tariff structure is both byzantine and uncertain (due to constantly shifting tariff policy), raising costs for US importers and customs officials alike, while simultaneously providing ample opportunity for corruption and rent-seeking.

While defenders of the current US tariff policy have some seemingly worthwhile aims, it is unlikely that these goals will be met by the new US tariffs. Consider two prominent rationales for these tariffs: addressing US trade imbalances and increasing US manufacturing production. Tariffs are unlikely to address US imbalances, since they do not address the root cause of the imbalances. The United States is a net borrower, driven in large part by the large fiscal imbalances of the US federal government, now running budget deficits that exceed 6 percent of GDP in a time of peace and full employment. While tariffs will reduce imports, they will also reduce exports, since tariffs reallocate resources in the economy toward import-competing industries and away from export industries; exports will also be harmed by retaliation, possible dollar appreciation, and the negative competitiveness impact of paying higher costs for tariffed intermediate goods.

The tariffs are also unlikely to lead to a US manufacturing renaissance. On the contrary, US production will be harmed by higher input costs, supply chain disruption, and uncertainty. While import-competing industries will expand, other industries will contract in parallel, and efficiency costs will reduce the overall size of the US economy. Upward price pressure will take time to propagate through the system, in part due to the lagged effects of tariffs on intermediate goods' prices, but tariffs will inevitably lead to higher price levels.

In the end, the traditional case for tariffs is limited. In a rules-based system, tariffs can be useful as remedies or—on a temporary basis—to help industries adjust to new market conditions. But most traditional aims of tariffs are better met by other policy tools. The income tax can redistribute income, and subsidies can encourage strategic industries, both at a lower efficiency cost than deploying tariffs. Restricting trade with adversaries and reducing supply chain risk may entail a modest deployment of tariffs, but even those use cases will entail collateral damage while inducing trade reshuffling and therefore warrant judicious use. In contrast, the use of tariffs as a broad revenue source is misguided; the absence of broad tariffs in other rich countries is one testament to that policy lesson.

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