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Tariff escalation and welfare

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An important question in the context of the current trade war unleashed by the United States is this: how can import tariff escalation be used as an instrument for achieving macroeconomic objectives, such as accelerating economic growth and correcting current account imbalances? The question is also important for Pakistan, which is facing a massive trade deficit underpinned by high import growth.

To answer this question, let's begin by looking at the possible impact of import tariffs on both importing and exporting countries. Total demand in an economy for goods and services has two components: demand for domestically manufactured goods and that for foreign products. In the long-run, imports may be essential for economic growth, but they are a drag on domestic output in the short-run. For the importing country, the immediate effect of an increase in tariffs is to drive up the price of the product in the domestic market.

The higher price has multiple effects: it dampens import demand, discourages consumption by both final consumers and producers who use imported inputs, encourages domestic production, creates or at least protects jobs and racks up government revenue. In case the tariff is large enough — the prohibitive tariff as it's called — it may cause all imports to come to a halt. As a result, entire domestic demand will be served by domestic producers, who will step up investment. However, because of zero imports, prohibitive tariffs will deprive the government of an important source of revenue.

Thus, tariffs provide protection to the import-competing domestic industry, swell the size of the public kitty (provided they are not prohibitive), help narrow the trade imbalance and reduce the welfare of consumers who have to purchase more expensive domestic products than they would otherwise. As a rule, it's the inefficient industries that need protection. So resources are diverted from more efficient to less efficient sectors, resulting into efficiency, or the deadweight loss. In case the importing country is a small one and its imports account for only a fraction of the world import of the product concerned, the international price of the product will not fall.

A tariff increase by Pakistan may force its trading partners to retaliate by reducing market access to our exports

However, in case an economy is large enough, such as the United States, the tariff increase will depress world prices, lower the output of exporting countries and improve importing country's terms of trade (the difference between export and import prices) relative to its trading partners. The only way exporters can maintain their share in the importing country's market is to bring down their prices, which will further deteriorate the exporting country's terms of trade. Because the terms of trade bear upon an economy's overall welfare, a large importing country is in a strong position to gain from the imposition of higher tariffs.

It goes without saying that the countries hit by the tariff increase will retaliate as several US trading partners have done. However, the effectiveness of their retaliation is a function of the size of their economy. A relatively small country pitted against a much larger nation will find it exceedingly difficult to punish the latter in equal measure. With the foregoing in view, it will be easier to understand why President Trump embarked on the trade war.

What benefits can Pakistan draw in case it chooses to increase tariffs on its major imports to reduce its trade imbalance? Unlike the United States, Pakistan has a considerable difference between its bound tariffs — notified to the World Trade Organisation (WTO) — and applied tariffs. Instead of imposing additional tariffs as done by the United States, Pakistan can simply increase its applied tariffs. It will not encounter any legal problems as long as the new applied tariff rates are within the bound rates. However, as far as achieving important policy objectives is concerned, the case of Pakistan (a small country) is different from that of the United States (a large country).

The increased tariffs will shore up public revenue, reduce imports and give protection to the domestic industry. Higher domestic prices will encourage higher output. However, being a relatively small country, Pakistan is not in a position to depress international prices by cutting back on its imports. Thus any terms-of-trade benefits, which may accrue to the United States, will not accrue to Pakistan. On the contrary, higher tariffs may worsen Pakistan's terms of trade by driving up import prices. As a result, Pakistan will be importing less (volume-wise) but at higher prices. Being a developing country, Pakistan needs to import machinery, equipment and intermediate goods in sufficient quantities to maintain the growth momentum. Terms-of-trade deterioration will constrain the ability to import industrial goods and raw materials, which will slow down growth.

If higher tariffs are imposed on intermediate products or machinery and equipment, the cost of doing business will go up, which may adversely affect export competitiveness. In any event, tariff escalation will be inflationary. Besides, a tariff increase may force Pakistan's trading partners to retaliate by reducing market access for our exports. The worsening terms of trade together with a possible fall in exports will drive down the exchange value of the rupee, which has already witnessed a sharp deterioration in recent months.

As the example of Turkey shows, the United States imposed higher tariffs for both trade and non-trade reasons. At present, Pak-US relations are not at their best, to say the least. In particular, the United States does not look upon with approval Pakistan's role in Afghanistan. In case the United States, which is Pakistan's single largest export market, decides to punish Islamabad by raising tariffs on the products of its export interest, it may result in considerable decline in overall exports. In that event, Pakistan will have the option to retaliate. However, as stated above, an economy's ability to effectively retaliate against a trading partner is a function of their relative size.

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