Why Trump’s tariffs are better than you think — and much worse

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7 July 2025

ACE2025 ECONOMICS FOR A CHANGING WORLD

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When economists tell you Donald Trump is *all* wrong about foreigners paying for his tariffs, don’t believe them. When large countries trade, they move prices.

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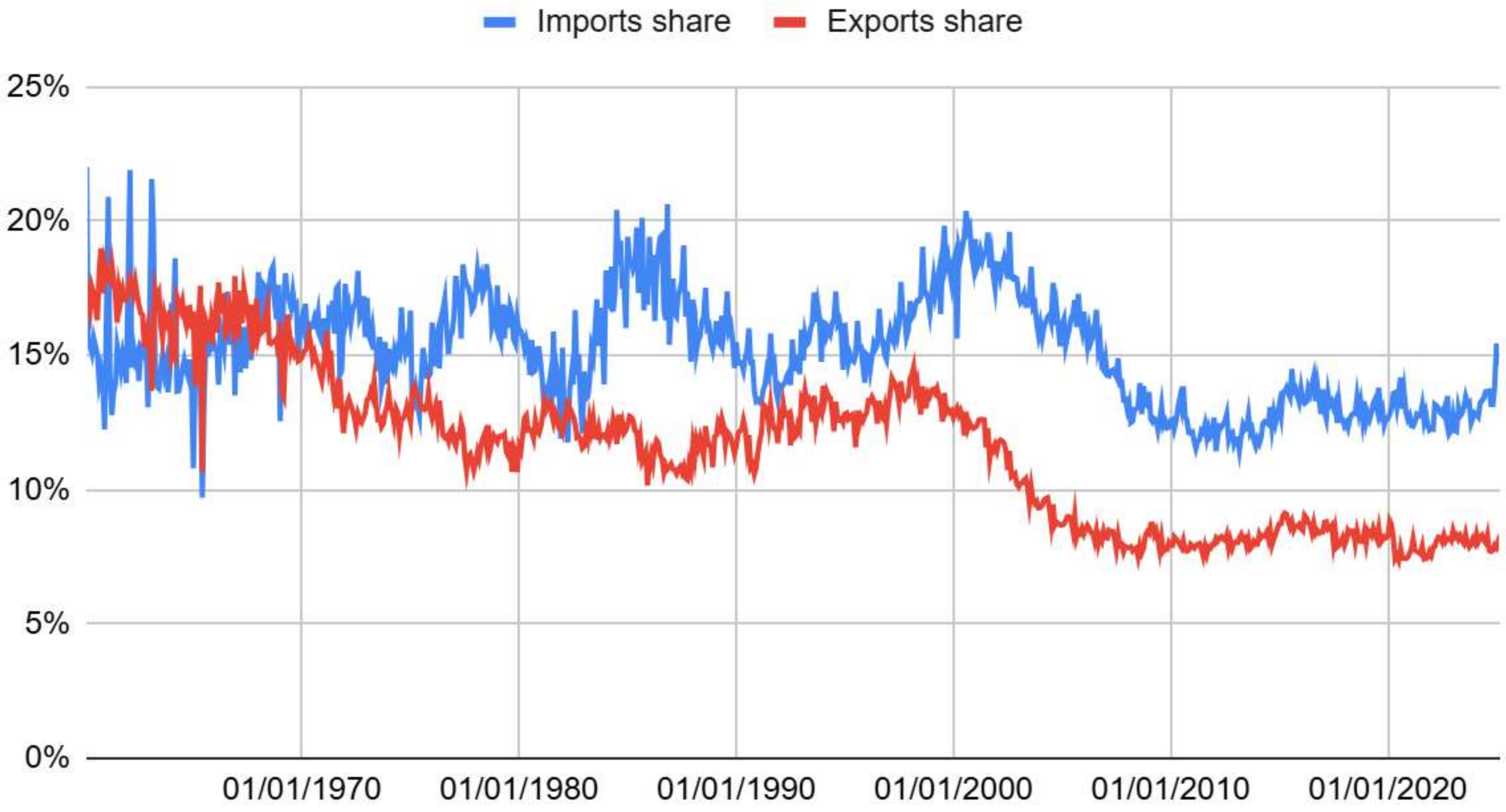
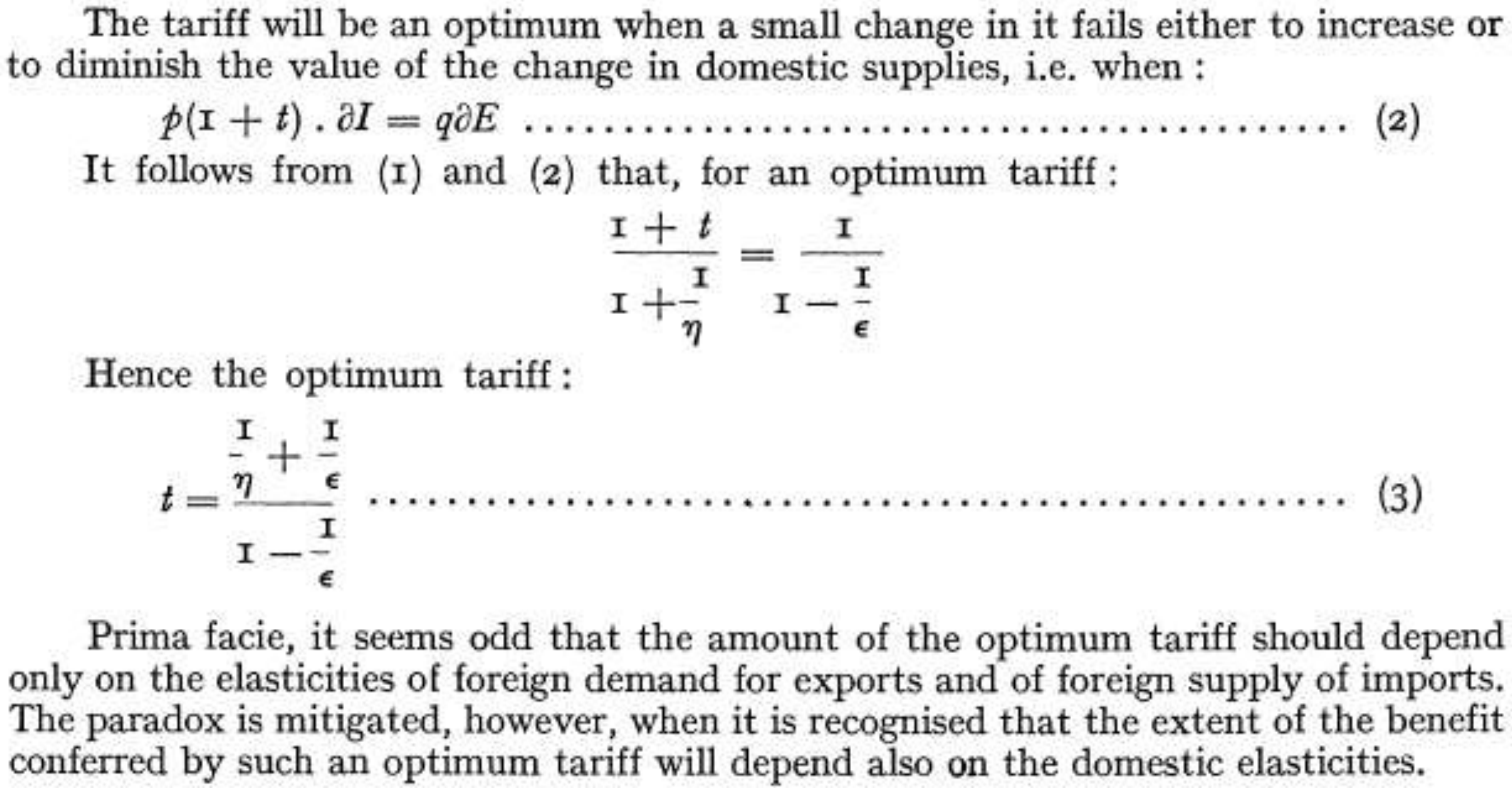
MAR 6, 2025 • 3 MIN READ

The US remains a large importer of world merchandise goods



From Kahn (1948) on Tariffs and the Terms of Trade, RES, 15, 1, p. 16.



The tariff will be an optimum when a small change in it fails either to increase or to diminish the value of the change in domestic supplies, i.e. when :

$$p(1+t) \,.\, \partial I = q \partial E \quad \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots \quad (2)$$

It follows from (1) and (2) that, for an optimum tariff :

$$\frac{1+t}{1+\frac{1}{\eta}} = \frac{1}{1-\frac{1}{\epsilon}}$$

Hence the optimum tariff :

$$t = \frac{\frac{1}{\eta}+\frac{1}{\epsilon}}{1-\frac{1}{\epsilon}} \quad \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots \quad (3)$$

Prima facie, it seems odd that the amount of the optimum tariff should depend only on the elasticities of foreign demand for exports and of foreign supply of imports. The paradox is mitigated, however, when it is recognised that the extent of the benefit conferred by such an optimum tariff will depend also on the domestic elasticities.

Illustrative optimal tariff for US

To illustrate the optimal tariff logic only. Not a forecast of policy impact.

Assume Eta = 7, i.e. if the US pays 1% less for imports, supply falls 7%.

Assume Epsilon = 20, i.e. if the US charges 1% more for exports, demand for its exports fall 20%.

The optimal tariff is around 20%.

If no market power in exports (i.e. Epsilon is infinite), optimal tariff is around 14%.

Welfare impact of highly stylised example	**USD billions**
Triangle of lost consumer surplus	-75.2
Foreigners' effective contribution to tariff revenue	88.6
Terms of trade gain for exports	42.3
Avoided excess burden of income tax	78.5
Net welfare gain	134.2

Stolper-Samuelson theorem

Country	Abundant factors (favouring free trade)	Scarce factors (favouring protection)
US (pre-1900)	Land	Labour, Capital
US (post-1900)	Land, Capital	Labour
England (post-1750)	Labour, Capital	Land
Germany (pre-1870)	Labour, Land	Capital
Germany (1870-1960)	Labour	Capital, Land
Germany (Post-1960)	Labour, Capital	Land

Source: Berstein, William (2008) A Splendid Exchange: How Trade Shaped The World.

United States, Foreign Trade, Taxes, Tariffs, Average Rate on All Imports

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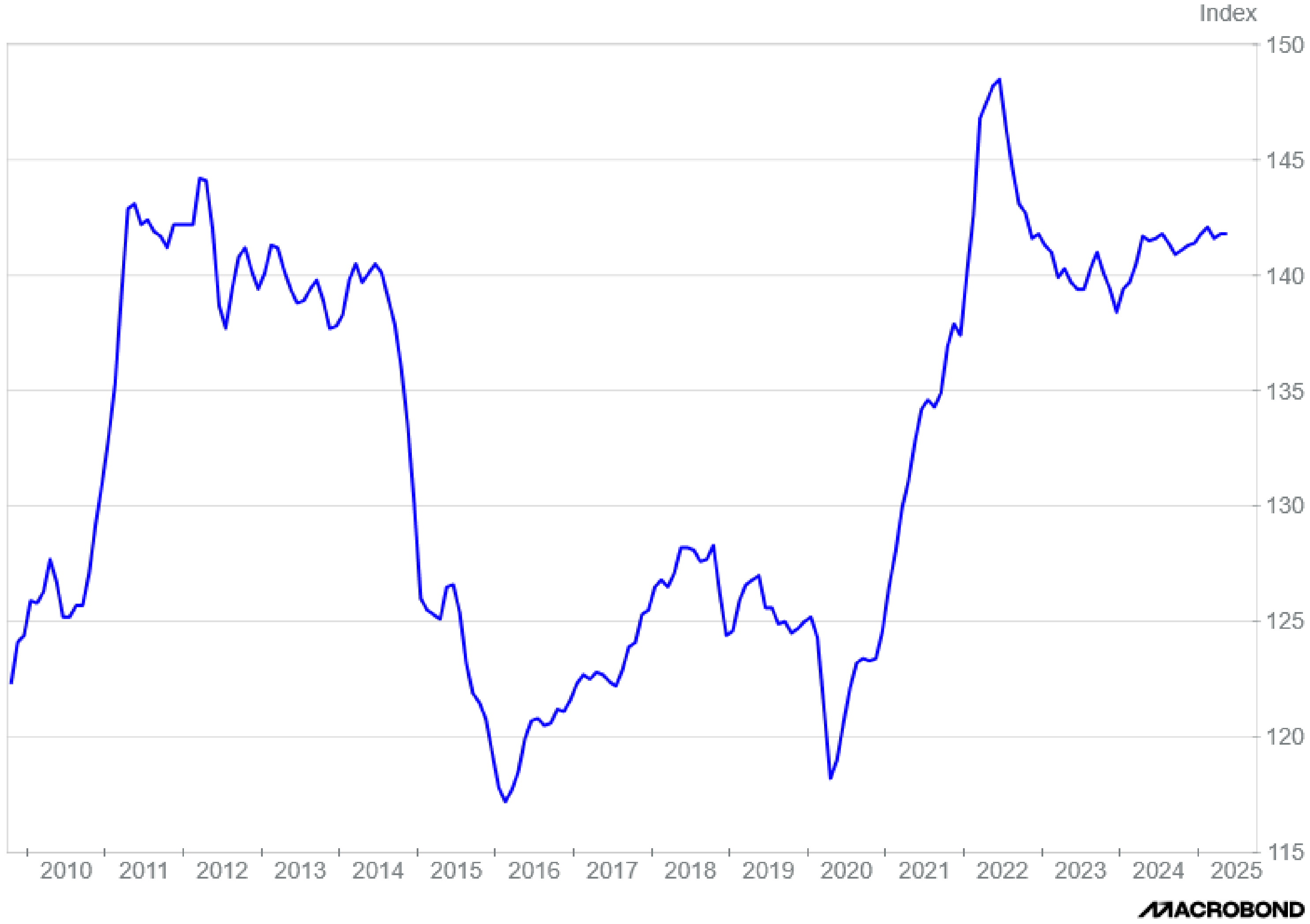
United States, Import Prices, All Commodities, Index



Policy lessons

- Theory suggests a tariff can be ‘optimal’ in certain circumstances, where a large country doesn’t fear retaliation, but history cautions against even a large nation trying this strategy.
- At moderate tariff rates, welfare gains from further tariff cuts are relative levels. In Australia, the case for reducing the 10% passenger motor vehicle tariff to 5% was less compelling than theory and initial modelling suggested.
- Australia’s relatively successful trade liberalisation was partly due to other policy settings, a social security and public health system, which meant impacts on affected groups weren’t as acute as in the US.