Chief economist's comment

Who pays the trade protection tax?

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- Trade protection is a tax on consumption. If the US applies a tariff or border tax, or otherwise imposes trade restrictions, the lowest income groups will generally be hit hardest. Only if trade protection is applied to new vehicles are higher income groups more adversely affected.
- Trade protection against China would hurt US consumers more than if it were imposed on Europe, and such protection levied on Europe would hurt them more than if it were adopted against Mexico.
- The effect of a trade protection tax may give rise to some disinflation in Europe if supply destined for the US is redirected.

Trade tariffs, border taxes, and trade protection are a tax on consumers. Protectionism may help some people by sparing jobs in less-efficient domestic industries. But consumers subsidize these jobs via the tax, which forces them either to pay higher import prices or purchase more expensive domestic goods and services. Like all taxes, trade protection taxes have the potential to redistribute income among different groups in the economy.

There is an obvious presentation issue with protectionism, whose benefit is narrow but deep – "1,000 new jobs have been created" – and whose cost is broad but shallow. Everyone pays a little more for the goods and services they buy. Economically, the costs of protectionism exceed the benefits, but bragging about "1,000 jobs created" has a greater impact on Twitter than "0.2% added to your weekly shopping bill."

As concerns about inequality rise, it is important to consider where the burden of a trade protection tax would fall. Sales taxes are rarely distributed evenly. Since different people buy different goods and services, they are affected unequally. If the US government chooses to engage in protectionism, which groups in society will pay most for it?

It is possible to use two data sets to get a sense of who will bear what share of the burden. The OECD's Trade in Value-Added database tells us how much domestic spending goes to goods and services imported from overseas. The survey of consumer spending breaks down the buying patterns of different groups in society, enabling us to create a relative index of who pays for tariffs. *A higher reading on the index means a greater chance that protectionism will cause the cost of living for that income group to increase.*

Fig. 1 illustrates the effect of trade protection on different consumption patterns. Applying a tax to new-car imports hits high-income earners far more than low-income ones. Levying it on food imports is far more serious for lower-income earners. These figures only take into account first-round effects, so the impact of rising new-car prices on used-car prices is not considered. A trade protection tax on cars would therefore be progressive (affecting higher-income groups more than lower-income ones). Applying it to food would hurt lower-income consumers more and would thus constitute what economists call a regressive tax.

The role of cars is crucial. Only by applying a tax on cars could trade protectionism be progressive. Otherwise, it hurts low-income people far more markedly than higher-income ones. Fig. 2 shows the effect of a tax imposed on all foreign trade, excluding autos.

Does a border tax, if applied, change this? A border tax effectively taxes imports but can lower domestic production costs by funding a reduced domestic corporate tax rate, so such savings could be partly passed on to consumers via lower prices.

However, if there is insufficient domestic industrial capacity to replace imports of a specific product (clothing, for instance), a border tax will merely raise its price. If that product is disproportionately important to lower-income groups, they will pay the taxes that fund the lower corporate taxes.

What if the border-taxed imports remain cheaper than the domestic goods (perhaps because the lower corporate tax is passed on to shareholders rather than consumers)? Imports will then still be consumed by lower-income groups, who again will pay a de facto sales tax that finances reduced corporate taxes.

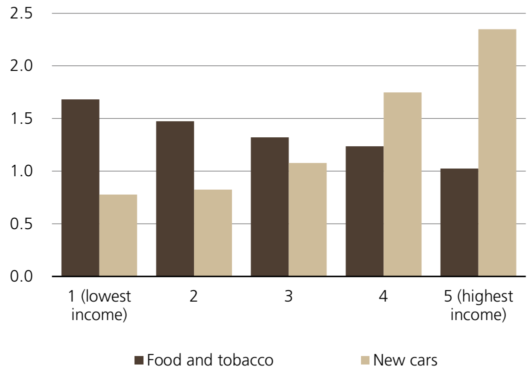
In Fig. 3, we can see how a universal tariff affects a country. In all cases, low-income groups suffer a greater loss in living standards than middle-income groups. This is not surprising since middle-income groups tend to spend a higher proportion of their income on services, which have less foreign input.

A universal tariff against China would do more damage to US living standards than one levied against Mexico or Europe. Again, this is unsurprising because Mexican exports to the US tend to have much higher US content than the goods the US imports from China do. Targeting Chinese content in goods (China exports few services) would damage the US consumer more than the US worker.

Excluding the auto sector from the country-based analysis makes the regressive nature of a trade protection tax clearer (see Fig. 4). Consumers, even US consumers, do not buy a new car every month. Consumer inflation perceptions are affected by the price of things purchased frequently. So

Fig. 1: Impact of a trade protection tax applied to autos and food, by US income group

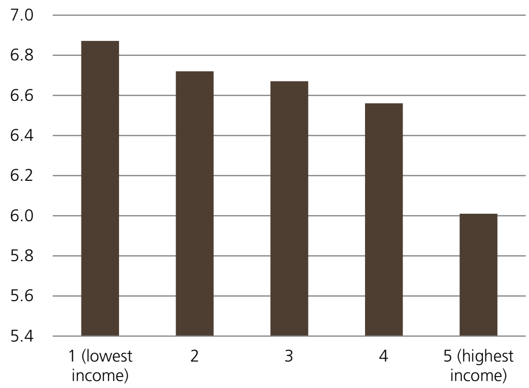
Values on left-hand side indicate index of trade protection costs



Source: OECD, BLS, UBS calculations

Fig. 2: Impact of a trade protection tax by US income group, all goods and services ex-autos

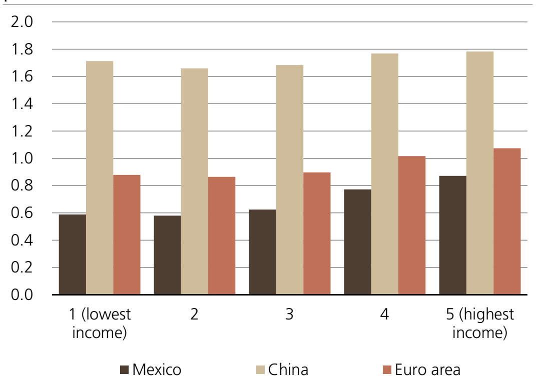
Values on left-hand side indicate index of trade protection costs



Source: OECD, BLS, UBS calculations

Fig. 3: Impact of a trade protection tax by US income group, all goods by country

Values on left-hand side indicate index of trade protection costs



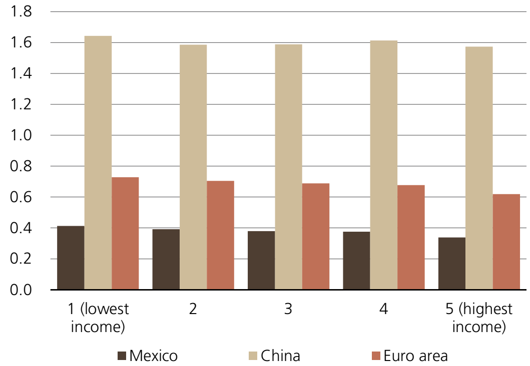
Source: OECD, BLS, UBS calculations

perceptions of real living standards tend to be influenced by high-frequency purchases. If a trade protection tax appears mildly progressive only when new autos are being purchased, most people will believe that it is actually regressive. This "alternative fact" may weigh on confidence.

Europe does not escape the consequences of US protectionism. But the impact of whatever form the measures might take is likely to lower Eurozone inflation. In this sense, protectionism is a bit like trade sanctions in reverse. If a tax succeeds in altering demand for imports in the US, goods previously sold there will be diverted elsewhere. Europe is likely to receive a disproportionate share of any diverted goods because it has similar consumption patterns to the US.

Ultimately, international production could decline, but at least initially Europe should enjoy cheaper imports (and possibly cheaper domestic products). Something similar happened to food prices in the wake of escalating sanctions against Russia, as previously exported agricultural product found its way onto the domestic market.

Fig. 4: Impact of a trade protection tax by US income group, all goods ex-autos by country
Values on left-hand side indicate index of trade protection costs



Source: OECD, BLS, UBS calculations

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