Discussion on Making America Great Again? The Economic Impacts of Liberation Day Tariffs

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[1]The views expressed here are those of the author and are not necessarily reflective of views of the Federal Reserve Bank of Chicago and the Federal Reserve System.

Summary: a great paper

- Question: What are the macroeconomic implications of the "Liberation Day" tariffs? Are those tariffs optimal?
- Framework: a Melitz Model with destination specific markups, free entry, and fixed costs paid in local labor (Demidova et al. 2024)
- Key Findings:
  - Unilateral tariffs improve US terms of trade and decrease trade deficits, improving welfare, particularly when tariff revenues are used to lower the income tax. However, welfare worsens under reciprocal retaliation.
  - The optimal unilateral tariff uniformly apply to all countries, as function of the aggregate trade deficit, rather than bilateral trade deficits, implying a **uniform 19% optimal tariff**

Model building blocks 1

- The share of country n's expenditure on country i

$$\lambda_{in} = \frac{(d_{in}/(A_i L_i^{\psi}))^{-\epsilon}(1+t_{in})^{-\phi_i \epsilon} w_i^{-\epsilon}}{\sum_j (d_{jn}/(A_j L_j^{\psi}))^{-\epsilon}(1+t_{jn})^{-\phi_j \epsilon} w_j^{-\epsilon}}$$

  - trade elasticity ϵ
  - scale elasticity: ψ
  - the pass-through of tariffs to prices in country i: ϕ_i

Model building blocks 2

- Labor demand for country i as:

$$L_i^D = \frac{1}{w_i}\left[\sum_n \frac{1-v_n}{1+t_{in}}\lambda_{in}E_n + \sum_n \frac{v_i}{1+t_{ni}}\lambda_{ni}E_i\right]$$

  - by domestic production
  - by foreign and domestic firms for fixed costs to sell in country i

- Labor supply implied by GHH preferences

$$L_i^S = \left(\frac{(1-\tau_i)w_i}{P_i}\right)^{\kappa}$$

- Equilibrium where labor and goods markets clear for all countries:

$$L_i^D = L_i^S$$

$$E_i = w_i L_i + R_i + \overline{T}_i$$

Endogenous Trade Deficit

- Trade deficit of country i:

$$D_i = \overline{T}_i + \sum_{n \neq i} \left[\frac{v_i}{1 + t_{ni}} X_{ni} - \frac{v_n}{1 + t_{in}} X_{in} \right]$$

- Determined by exogenous lump sum transfers ($\overline{T}_i$) and endogenous components, incorporating labor costs and fixed costs

Unilateral Optimal Tariff

- **Key result:** The optimal tariff is increasing in the aggregate trade deficit but is independent of the bilateral deficits.

- Tariffs leverage monopoly power over differentiated labor by curbing demand for foreign labor and raising domestic wages relative to foreign. With deficits, larger import reduction is needed to achieve the optimal relative wage.

Comment: Generality of Key Result

- Fixed costs paid by importing country in terms of local labor
- An extension to multi sectors
- An extension to intermediate inputs
- Costly labor mobility (in a multi-sector or multi-state setup): immobility for short run
- Difference with Pujolas and Rossback (2024)

Comments:

- Estimation of fixed cost v_i
  - The authors estimated two v's: the U.S. and non-U.S. countries
  - How about v across foreign countries?
  - More realistic: divide fixed costs between producing and destination countries
- Retaliation
  - The model predicts that retaliation improves foreign welfare
  - Empirically, we observe very limited retaliation so far
  - Standard trade theory focusing on welfare and efficiency doesn't fully capture the political economy of U.S. tariff policy.