22-4 For Inflation Relief, the United States Should Look to Trade Liberalization

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INTRODUCTION

With inflation running at 40-year high rates, President Joseph R. Biden Jr. is wringing his hands and the Federal Reserve is signaling more interest rate hikes in 2022 and 2023. But policymakers are overlooking one set of actions that could make a meaningful contribution to taming inflation: trade liberalization. The data cited in this Policy Brief indicate that a feasible package of liberalization could deliver a one-time reduction in consumer price index (CPI) inflation of around 1.3 percentage points.

That reduction would amount to $797 per US household, about half the size of pandemic relief in 2021. As a bonus, the embrace of trade liberalization would curb inflationary expectations taking hold in American firms now protected by trade barriers from foreign competition.

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GOAL: LIBERALIZATION EQUIVALENT TO A 2 PERCENTAGE POINT REDUCTION IN TARIFFS

In a PIIE blog, Katheryn Russ explores the direct impact on US inflation of US tariffs imposed specifically on imports from China. Her research shows that these particular tariffs only marginally raised costs for US consumers and firms. But inflation can be meaningfully reduced if one looks at a broader array of tariffs.

To make a show of combating inflation, the Biden administration has rolled out an anti-monopoly strategy, arguing that lack of competition and high profits in the energy sector, among others, are contributing to high prices. But some press reports indicate that Treasury officials have argued privately that relaxing tariff duties would also ease price increases hitting American consumers.

Table 1
US imports sitting under high tariffs, penalty duties, or severe quotas, 2021

Protective policy	Approximate 2021 import value affected by high protection (billions of US dollars)
Antidumping and countervailing duties[a]	112.0
Most favored nation tariffs between 10 and 20 percent on agricultural products	1.1
Most favored nation tariff greater than 20 percent	21.2
Trump's trade war tariffs[b]	336.0
Buy America[c]	90.0
Section 232 steel tariffs	33.5
Generalized System of Preferences (GSP)	16.0
Tariffs on Moroccan potash fertilizer[d]	0.7
Total	**610.5**

a. Based on Bown (2022), 4.3 percent of US imports from G20 countries in 2019 were covered by antidumping or countervailing duties. To give a rough estimate for 2021 and for all US imports, we use 4 percent to multiply 2021 total US imports from the world.

b. Based on Bown (2021), 66.4 percent of US imports from China in 2017 were covered by the trade war tariff. To roughly estimate this for 2021, we take US imports from China in 2021, $506 billion, and then multiply that by 66.4 percent.

c. In his 2022 State of the Union Address, President Biden said: "The federal government spends about $600 billion a year to keep the country safe and secure." Without Buy America, we estimate about 15 percent of that number would probably be imported.

d. There may be slight double counting between this policy and the first one in this table, "Antidumping and countervailing duties."

Sources: Chad P. Bown, *Trump ended WTO dispute settlement. Trade remedies are needed to fix it*, PIIE Working Paper 22-1 (2022, Washington: Peterson Institute for International Economics); Chad P. Bown, US-China Trade War Tariffs: An Up-to-Date Chart, PIIE Chart (March 16, 2021, Washington: Peterson Institute for International Economics); Congressional Research Service, *Generalized System of Preferences (GSP)*, CRS Report No. IF11232 version 7 (updated January 13, 2022, Washington); White House, Remarks of President Joe Biden–State of the Union Address As Prepared for Delivery (March 1, 2022, Washington); US Census; US International Trade Administration Steel Import Monitor; US International Trade Administration, Final Determination in the Countervailing Duty Investigations of Phosphate Fertilizers from Morocco and Russia (February 19, 2021).

If the White House takes these views seriously, it should set itself a liberalization target equivalent to a 2 percentage point tariff reduction. To put that goal in context, President Donald Trump inflicted Americans with $81 billion[1] higher costs by imposing an additional 16 percent average tariff on $506 billion of imports from China. All told, over $610 billion of US imports in 2021 were subject to high tariffs, penalty duties, or severe quotas (table 1), and $949 billion of US imports were subject to some form of import duty. Two percentage points of tariff-equivalent relief on the $2,800 billion of US merchandise imports in 2021

1 Calculated as follows: $81 billion = 16 percent * $506 billion.

would be equivalent to $56 billion[2] in lower costs for Americans. If President Trump can raise costs for average households by $81 billion, President Biden can at least lower those costs by $56 billion.

A long list of possible liberalization measures can be envisaged, though each one faces a challenging battle from vested interests and in Congress. This Policy Brief offers illustrative examples. The core message is that President Biden needs to assign the US Trade Representative, the Treasury, and the Council of Economic Advisers the task of assembling a package that meets the 2 percentage point goal.

LOWER IMPORT PRICES HELP REDUCE CPI INFLATION

US imports of goods amounted to $2.8 trillion in 2021, a year when US GDP reached $23.0 trillion. In other words, imports amount to roughly 12 percent of GDP. Not surprising, imports contribute to 12 percent of the CPI. Some elements of trade liberalization would quickly reach consumers through lower prices at retail outlets like Amazon, Target, and Walmart. Other elements would take longer to reach consumers as they reduce the cost of intermediate goods, the largest component of US imports, and gradually lower prices of finished goods delivered by US firms to American households. As the 2 percentage point tariff-equivalent liberalization eventually makes its way to consumer prices through a chain of intermediate transactions, the one-time impact would lower CPI inflation by about one-quarter of 1 percent (12 percent times 2 percentage points equals 0.24 percentage point).

ENHANCED COMPETITION REDUCES THE COST OF DOMESTIC GOODS

Based on Sherman Robinson and Karen Thierfelder's computable general equilibrium (CGE) analysis,[3] when imports are highly interchangeable with domestically produced goods (in technical terms, a "high elasticity of substitution"), CPI inflation would be reduced by 0.67 percentage point for each 1 percentage point decrease in tariff-equivalent import barriers.[4] Substitution means that less expensive imported goods compete with more expensive domestic goods, leading to a shift in purchasing patterns and putting pressure on prices charged for domestic goods. As well, competition may compel domestic firms to trim their markup margins, especially in this era of high corporate profits.

Based on the Robinson-Thierfelder coefficient, the competitive impact of a 2 percentage point decrease in tariff-equivalent barriers could reduce CPI inflation by 1.34 percentage points (0.67 times 2 percentage points). From this figure, to avoid double counting, we subtract the 0.24 percentage point direct impact calculated above, giving a 1.1 percentage point reduction in CPI inflation for the competitive effect (see top row in table 2).

2 Calculated as follows: $56 billion = 2 percent * $2,800 billion.

3 Based on data supplied by Robinson and Thierfelder underlying their PIIE blog, "Can liberalizing trade reduce US CPI inflation? Insights from an economywide analysis," RealTime Economic Issues Watch, Peterson Institute for International Economics, March 29, 2022.

4 The scenario in the blog by Robinson and Thierfelder specified a uniform imposition of a tariff of 10 percentage points on all imports, and they report a 6.7 percentage point increase in CPI inflation (or 0.67 for each 1 percentage point tariff). The same effect would work for a decrease in tariffs with a reduction in CPI inflation.

ADDING UP THE TRADE LIBERALIZATION RELIEF OF INFLATION

These back-of-the-envelope calculations indicate that a 2 percentage point reduction in tariff-equivalent barriers would deliver a one-time decrease in CPI inflation of 1.3 percentage points (0.2 percentage point plus 1.1 percentage points). While a 1.3 percentage point haircut might seem small when inflation is raging at more than 7 percent, the relief is not trivial. In more normal times, when CPI inflation is running at 2 percent annually (the Federal Reserve's target rate), a 1.3 percentage point one-time decrease would be quite noticeable. Moreover, since lower-income households consume a larger proportion of their income than upper-income households, trade liberalization counts as progressive policy in the same way that cutting a sales tax is progressive policy. To make trade liberalization even more progressive, the Biden administration could target imported goods that figure more in lower-income households expenditures, such as school supplies, clothing, and furniture.

EXAMPLES OF INFLATION RELIEF

Several examples, expressed in terms of average household income and expenditure and individual product categories, illustrate the magnitude of relief. These are summarized in table 2.

- According to the US Consumer Expenditure Survey, the average US household spent $61,334 on goods and services in 2020. A decrease of 1.3 percentage points in CPI inflation would save that average household $797 annually. That is a good number for government work.
- Trump's tariff war against China flopped as an engine for US exports. But it inflicted an additional average tariff of 16 percent on US firms and households that purchased $506 billion of Chinese goods in 2021. Americans, not Chinese exporters, paid the tariff. Eliminating the tariff would save US firms and households about $81 billion annually on direct purchases from China. It would save them considerably more as competition lowered the price of similar US goods. The tariff-equivalent reduction is 2.9 percentage points ($81 billion divided by $2,800 billion) on all US goods imports, which corresponds to a 0.3 percentage point reduction in CPI inflation directly through lower import prices.
- Strict Buy America rules exclude foreign competitors from US government procurement, thereby abetting price gouging on federal contracts. While the concept of Buy America is dear to President Biden, so is the concept of competition. Buy America rules cost the US government $100 billion annually by excluding foreign competitors. The president could stop the gouging if he specified a reasonable margin of preference for US firms when they bid for government work. For example, foreign bids could be accepted when they are 15 percent or more below the cheapest bid from a US contractor. This would save taxpayers at least $25 billion annually, equivalent to a tariff-equivalent reduction of 0.9 percentage point on all US goods imports, which corresponds to a 0.1 percentage point direct reduction in CPI inflation, and it would be an important signal to government contractors.

Table 2
Direct and competitive effects of liberalization measures on US consumer price index (CPI) inflation

	Action	Direct effect through lower import prices	Competitive effect through lower domestic prices	Possible long-term effect
		(1)	*(2)*	*(1) + (2)*
	Liberalization goal set in this Policy Brief			
	2 percentage point tariff-equivalent reduction	0.2 percentage point reduction in CPI inflation	1.1 percentage point reduction in CPI inflation	1.3 percentage point reduction in CPI inflation
	Total			**1.3 percentage point reduction in CPI inflation**
	Specific tariff reduction measures			
1.	Eliminate Trump's trade war tariffs	2.9 percentage point tariff-equivalent reduction, corresponding to 0.3 percentage point reduction in CPI inflation	0.96 percentage point reduction in CPI inflation (Robinson and Thierfelder's 1.3 percentage points[a] minus 0.3 percentage point [direct effect item (1)] minus 0.04 percentage point [direct effect item (2)]; direct effect of item (3) is negligible and thus not factored in here)	1.3 percentage point reduction in CPI inflation
2.	Dismantle Trump's 25 percent Section 232 "national security" steel tariffs	0.3 percentage point tariff-equivalent reduction, corresponding to 0.04 percentage point reduction in CPI inflation		
3.	Waive penalty duties on Canadian lumber	Saving of $33 million		
4.	Relax Buy America rules	0.9 percentage point tariff-equivalent reduction, corresponding to 0.1 percentage point reduction in CPI inflation	0.5 percentage point reduction in CPI inflation (0.9 percentage point tariff-equivalent reduction * 0.67 [Robinson-Thierfelder coefficient] – 0.1 percentage point [direct effect]).	0.6 percentage point reduction in CPI inflation
5.	Cap "peak tariffs" at 10 percent	0.14 percentage point tariff-equivalent reduction, corresponding to 0.02 percentage point reduction in CPI inflation	0.07 percentage point reduction in CPI inflation (0.14 percentage point tariff-equivalent reduction * 0.67 [Robinson-Thierfelder coefficient] – 0.02 percentage point [direct effect]).	0.09 percentage point reduction in CPI inflation
6.	Renew GSP and waive the Competitive Need Limit	Saving of $2.4 billion		
7.	Waive penalty duties on Moroccan potash fertilizer	Saving of $140 million		
	Total	**4.2 percentage point tariff-equivalent reduction, corresponding to 0.5 percentage point reduction in CPI inflation**	**1.5 percentage point reduction in CPI inflation**	**2.0 percentage point reduction in CPI inflation**

	Action	Direct effect through lower import prices	Competitive effect through lower domestic prices	Possible long-term effect
		(1)	*(2)*	*(1) + (2)*
	Other examples of inflation relief			
8.	Waive the Jones Act for Hawaii and Puerto Rico	Save each Hawaiian family $1,800 and each Puerto Rican family $500 a year		

GSP = Generalized System of Preferences

a. In their blog, "Can liberalizing trade reduce US CPI inflation? Insights from an economywide analysis," Robinson and Thierfelder find that if the United States and China eliminated their trade war tariffs and the United States eliminated tariffs on steel and aluminum from all countries and softwood lumber from Canada, which correspond to items (1), (2), and (3) in this table, CPI inflation in the United States would decline by 1.3 percentage points from its base level. We subtract from it the direct effect of items (1) and (2) to avoid double counting. We equate the remaining 0.96 percentage point to the competitive effect of the three items.

Source: Authors' calculations.

- President Biden's call for competition would have meaning if he truly dismantled Trump's 25 percent Section 232 "national security" steel tariffs. Instead, Biden has replaced those tariffs with quotas that give little relief to US steel-using firms. Since 2018, when tariffs were imposed, the top 5 US steel firms—Nucorp, ArcelorMittal, Steel Dynamics, Cleveland-Cliffs, and U.S. Steel—have cried all the way to the bank. Steel prices more than doubled and collective profits of the top 5 steel firms soared from $11.0 billion in 2018 to $31.9 billion in 2021. Steel imports in 2021 amounted to $34 billion. A repeal of the bogus national security tariff and equivalent quotas would save American steel-using firms $8.5 billion (25 percent of $34 billion), or a tariff-equivalent reduction of 0.3 percentage point on all US goods imports, which corresponds to a 0.04 percentage point reduction in CPI inflation directly through lower import prices.
- The US imposed "peak tariffs" of 20 percent or more in 2021 on $21 billion of imports from countries other than free trade agreement partners. Clothing, footwear, and dairy products, all staples for low-income Americans, were hit hard. Powerful dairy, clothing, and footwear firms would scream, but American shoppers would shout with joy seeing supermarket prices slashed if these tariffs were capped at 10 percent. To support small dairy farmers in America's heartland and rural areas hurt by cuts to tariff-quota protection on dairy, the US Department of Agriculture could beef up (pun intended) dairy subsidies. Assuming peak tariffs average 30 percent, a cap of 10 percent would directly save American households $4 billion (20 percent of $21 billion), or a tariff-equivalent reduction of 0.14 percentage point on all US imports, which corresponds to a 0.02 percentage point reduction in CPI inflation directly through lower import prices.
- The Generalized System of Preferences (GSP), which permits duty-free entry of exports from developing countries, expired on December 31, 2020. When reenacted by Congress, it should be liberalized. Specifically, Congress

should waive the Competitive Need Limit, now stipulated as $195 million per tariff line. Conceivably, GSP imports of about $16 billion in 2020 could double to $32 billion in 2023, giving Americans lower prices for items such as suitcases, jewelry, auto parts, and table lamps. Assuming the average tariff on GSP items from other suppliers is 15 percent, the saving to American households might reach $2.4 billion, important to them but a rounding error when compared with total US imports.

- "Unprecedented spikes" in lumber prices have added $36,000 to the cost of new houses, according to the National Home Builders Association. One reason for the spike is the doubling last November of high US antidumping and countervailing duties on lumber imports, together about 18 percent. This is just the latest episode in an irritating four-decade trade war with Canada. Congress should give the president authority to temporarily waive penalty duties when prices spike to this extent. If the duties were waived, American homebuilders would save $33 million on the $185 million of lumber imports from Canada subject to penalties (18 percent of $185 million). In the overall context of US imports, the saving is a rounding error, but symbolically important. Moreover, as recently as 2017, US imports of lumber from Canada amounted to $5.9 billion. Successive installments of the "lumber wars" have dramatically reduced US lumber imports and pushed up prices.
- Another candidate for "spike relief" is potash fertilizer: The United States imposes 20 percent countervailing duties on $700 million of imports from Morocco, a friendly country and free trade agreement partner, despite the burden on American farmers. Waiving the duties would save American farmers $140 million, important to them but again a rounding error when compared with total US imports.
- The Merchant Marine Act of 1920, also known as the Jones Act, ranks first among costly artifacts of US protection. By requiring ships that serve US coastal trade to be made in US shipyards and manned by US citizens, the Act more than doubles the cost of moving containers. Hawaii and Puerto Rico are especially hard hit since all their trade with the continental United States pays the Jones Act tax. The annual cost to each Hawaiian family is $1,800 and to each family in bankrupt Puerto Rico about $500. President Biden could waive the Jones Act at least to those two jurisdictions, using his executive authority.

TIME FOR ACTION

Inflation over 7 percent is the political equivalent of a house on fire. Strong action must be taken before today's inflation rate gets embedded in tomorrow's inflation expectations, igniting a wage-price spiral akin to the 1970s and 1980s that can be curbed only by deep recession. While trade liberalization is not the vanguard of anti-inflation forces, it can meaningfully support fiscal and monetary measures.

Taken together, the specific measures suggested in table 2 could deliver 4.2 percentage points of tariff-equivalent liberalization, far exceeding the 2 percentage point goal set out in this Policy Brief. A 4.2 percentage point tariff-equivalent reduction would reduce CPI inflation by 0.5 percentage point directly (through lower import prices) and possibly by 2.0 percentage points in the longer term (through lower import and domestic prices). While these measures are aimed at cutting tariffs on imported merchandise, it should not be forgotten that the United States also imposes significant barriers on service imports, particularly on insurance, air transport, courier services, and maritime transport, as documented by the latest Organization for Economic Cooperation and Development (OECD) Services Trade Restrictiveness Index (STRI) report. These service barriers are costly to American households. The US Trade Representative and the Council of Economic Advisers will find no shortage of potential liberalization measures if President Biden sets their collective mind to assembling a 2 percentage point tariff-equivalent reduction target.

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