Tariffs will hurt American innovation

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Donald Trump has been advocating policies that will reduce the volume of U.S. trade. He started off by calling for large across-the-board tariffs. These tariffs are taxes paid on imports into the U.S. So for instance, French wineries would pay this tax to sell their wine in the U.S. Then, French wineries would increase their prices in order to be able to afford to pay the tax. Facing higher prices for French wine, American consumers will purchase less of it. If Trump had adopted an across-the-board tariff policy, all of our imports would face this type of tax and the prices of all of these products would increase. As a result, U.S. consumers would have bought fewer foreign goods. This is one way that tariffs reduce America's trade.

There is a second way. If the U.S. imports fewer goods, then foreign companies do not accumulate as many U.S. dollars. With fewer dollars available, there won't be enough dollars for foreigners to buy the U.S. goods that they would like to purchase. Foreigners who really want U.S. products will agree to pay more of their local currency to get U.S. dollars. So a farmer in Portugal who really wants a John Deere tractor will agree to pay more Euros to get the dollars to pay John Deere. As other Europeans with a high demand for U.S. products face a shortage of dollars, they too will bid up the price of dollars, by paying more Euros to obtain each dollar. In contrast, other Europeans will see that American goods are more expensive (since these goods cost more Euros to buy) so the Europeans will buy fewer American goods – which is the second way that across-the-board tariffs will reduce America's trade.

Luckily, Trump has scaled back his plans to impose tariffs. His latest idea calls for the U.S. to impose reciprocal tariffs. So if one country imposed a 10 percent tariff on U.S. goods and a second country imposed a 25 percent tariff on U.S. goods, the U.S will levy a 10 percent tariff on the first country and a 25 percent tariff on the second one. Presumably, these reciprocal tariffs, when considered together, will be lower than the across-the-board tariffs Trump was originally contemplating.

So far, Trump seems to be moving toward freer trade – at least compared to his initial across-the-board tariff proposal. But I worry that he could change his mind and implement policies that further restrict U.S. trade.

To see the danger of trade restrictions, it is useful to consider an extreme case: when a country tries to eliminate trade and become self-sufficient. To be clear, Trump is not calling for such an extreme policy, he just hopes to move us in that direction.

In 1639, Japan's rulers cutoff almost all of Japan's international trade. Japan remained isolated for about 200 years until Commodore Perry sailed U.S. naval ships in Tokyo's harbor and demanded that the nation begin trading with outsiders again. The period of isolation was devastating. In the mid-1870s, Japan was still producing textiles using the production technology that Europe had been using in the 1700s. Without trade, its companies failed to innovate. They became stagnant because they did not face competition that forced them to stay efficient. Of course, when it opened up for trade, Japan's textile industry couldn't compete with the cheap imports coming in from Europe. Japanese workers had to leave the textile industry to find employment elsewhere.

Japan's complete withdrawal from international trade caused it to lag behind in technological innovation; Trump's policies that lead to a reduction in international trade will do the same. We have already seen its effect. The U.S. steel industry has enjoyed tariff protection since the Kennedy administration. These protections kept American companies from having to innovate to survive. They lagged so far behind the industry leaders that recently U.S. Steel was looking for a foreign buyer (Nippon Steel) who could bring the technology to U.S. plants that the domestic firms never developed while operating in their tariff-protected business environment.

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