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The Welfare Effects of Trump's Tariff Policy

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Abstract: We discuss the terms-of-trade effects of the import tariffs imposed by the US administration. Import tariffs benefit a large nation by suppressing the export price of the good it imports and by improving its terms of trade. This allows the large nation to move to a higher consumption point without the need for actual economic growth. The terms-of-trade gain is substantive for a large nation, while there is none for a small open economy. Borrowing on international trade theory we argue that the purpose of the import tariffs imposed by the USA is not merely to resolve trade balance issues, but rather to effortlessly improve the consumption position of the country.

Keywords: gains from trade; terms of trade; consumption position; community indifference curves; protectionism.

JEL Classification: F11; F13; F43; O41.

Introduction

In his second term as president of the USA Donald Trump initiated tariffs on imports from its key trading partners with the purpose of resolving the trade deficit of the country. The deficit on goods and services for 2025 is 59.6 billion dollars with a trade deficit on goods of 85.6 billion dollars and a surplus on services of 26.1 billion dollars (US Census Bureau; US Bureau of Economic Analysis; US International Trade in Goods and Services, November 19, 2025). The trade deficit is insignificant given the size of the country and its public debt. As of November 2025, the US total federal debt is estimated at 38.3 trillion dollars of which the debt held by the public is 30.6 trillion dollars (Joint Economic Committee 2025). The relation between the public debt and the trade deficit is only indirect according to the twin deficit hypothesis. In other words, the trade deficit of the country does not directly and significantly cause the immense public debt of the USA.

While the overall trade deficit on goods is insignificant, the goods trade deficit with China as of November 2025 stands at 295.5 billion dollars (Office of the US Trade Representative 2025) but the US trade surplus in services with China was 33.2 billion dollars in 2024. The US trade deficit on goods with the European Union approximates 235.9 billion dollars (Office of the US Trade Representative 2025). However, the USA has a surplus of 88.6 billion dollars on services with the EU which reduces the overall trade deficit with the EU to 147.3 billion dollars (Office of the US Trade Representative 2025). Thus, the main target of the newly instituted import tariffs are China and the European Union, due to the negative trade balance on goods, but import tariffs are also imposed on Canada and Mexico, the US direct neighbors and members of the North American Free Trade Agreement (NAFTA), a trading bloc which the USA also participates in.

The USA has seen consistent growth in the last 5 years. After the economic shock of Covid in 2020 with a decline of 2.1%, real GDP grew by 6.2% in 2021, 2.5% in 2022, 2.9% in 2023 and 2.8% in 2024 (US Bureau of Economic Analysis 2025). This shows the USA not as a static, but as a dynamic economy experiencing growth due to increased productivity, inflow of factors of production, technological or other factors.

1. Literature Review

Being large, the US economy is self-sustainable, that is, it can produce everything by itself and can exist on its own. It has a sufficient number of key resources (including oil) and the necessary technologies to produce essential

items. As an autarky a large economy does not realize the gains from trade but is capable of producing and self-sustaining for a long period of time, something which is impossible for a small economy. In addition to that, scale economies allow the nation to achieve economic efficiency and produce nearly everything more cheaply than a small nation.

It is assumed in this paper that the USA engages primarily in interindustry trade, that is, trade based on dissimilar factors of production. Our results are also consistent with intraindustry trade, but the presumption is that the USA exports goods whose intensive factors are abundant and imports goods whose intensive factors are scarce. This is in line with the Heckscher-Ohlin theoretical model of international trade. More specifically, we apply the tools of the standard trade model, as an extension of the Heckscher-Ohlin trade model and consistent with the Ricardian type of trade where countries exchange commodities for which they have a comparative advantage and are endowed in. Our assumption is that the USA specializes in goods in which it has comparative advantages and imports from the rest of the world commodities in which it does not have such.

We maintain that the USA imposes import tariffs as restrictions on trade with the purpose of increasing its welfare without substantially increasing production or improving economic efficiency in any way. At the same time, the import tariffs reduce the well-being of the rest of world. We hypothetically define the trading partners of the USA as "the rest of the world" and assume that generally the USA trades with two goods, exports and imports. The price of the exported good is assumed here to be P_x , while that of the imported good which is imported in the USA from the "rest of the world" is P_y. Thus, the terms of trade for the USA are $\frac{P_x}{P_y}$, that is, the value of the coutntry's exports over that of its imports. For the rest of the world, importing in the USA, the terms of trade are reciprocal, or $\frac{P_y}{P_x}$.

A number of authors emphasize the welfare effects of import tariffs (Caves, Frankel and Jones 2002; Ingham 2004; Gerber 2005). Gains from trade are emphasized by many scholars (Salvatore 1993a; Grubel 1981; Husted and Melvin 2007). Gruber (1981) analyzes community indifference curves to describe the consumption and preferences of a nation. The European Union is a customs union and a common market (Baldwin and Wyplosz 2004). It removes all trade barriers among member states but erects the same tariff barriers to non-member countries. Growth can be welfare improving especially when it is in the import-competing sector (Appleyard and Field 1998) but it could as well be immiserizing if it is in the export-oriented sector and the economy is large enough to influence world terms of trade to its disadvantage (Bhagwati 1958). Furthermore, it does not matter where growth occurs. As long as it is in the country's import-competing sector, it makes it better off since it reduces the world price of imports. If it is in the country's exports-oriented sector, it makes the country worse off since it lowers the relative price of the country's exported good thus worsening its terms of trade and reducing the country's overall well-being. There are terms-of-trade gains resulting from an import tariff (Krugman and Obstfeld 2003; Root 1990).

The USA has a long tradition in protectionism although in the last decades it has led relatively liberal strategic trade policies which foster free trade and general support for developing and transitional countries. The proponents of the "infant industry argument" first appeared in the USA. The argument bases protectionism on the need to give an impetus to an industry which is starting up and needs sufficient demand in order to evolve. This is especially true when the entry price of the newly developing domestic industry is higher than the costs and prices of the foreign firms which have already established themselves in the world. External economies of scale and dynamic increasing returns cannot be taken advantage of since the new and prospective industry cannot start without protection. A country which potentially has lower costs due to dynamic increasing returns cannot enter an industry because other countries are already incumbents in it and have a first-mover advantage. Banning importation guarantees demand to the domestic firms and allows them entry with the possibility to eventually take over the world market, once they settle in.

Alexander Hamilton, the first secretary of the Treasury of the USA, and Friedrich List, a German-born economist who migrated to the USA, propagated the use of tariffs to protect manufacturing so that to bring the American economy to the level of the most powerful economies in the world (Hamilton 1791; List 1904). In line with this policy president William McKinley (1843-1901) raised tariffs (Barbet 2025). It is believed that one of the triggers, if not the trigger, for the Great Depression in the late 1920s and 1930s was US protectionism. In 1930 the US Congress passed the Smoot-Hawley Act which imposed severe import tariffs to protect US farmers and industries. This unleashed a trade war with other countries which imposed retaliatory duties of their own. The world trade dropped by nearly two-thirds which led to a deep depression in Europe. By 1933 every fourth person (nearly 24% of the labor force) in the USA was unemployed as a result of the Depression.

The current trade war scenario with China is not new for the USA. In the past the country has been involved in a similar trade war with Japan. The war started in the 1950s but intensified between 1980 and 1990. Like Chinese ware nowadays, Japanese products such as electronics, cars, semiconductors, steel and textiles flooded the US

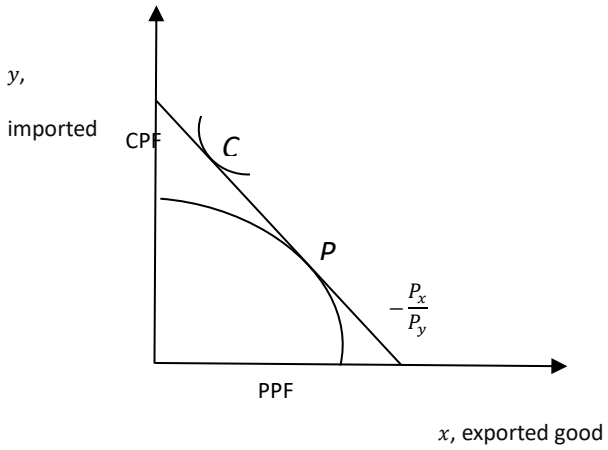
market at that time (Salvatore 1993b). Japan led strategic trade policies of neo-mercantilism. While Japan invaded the USA with its imports, it protected itself strongly against US imports of agricultural products using non-tariff barriers such as regulations, technical or other requirements. Using political pressure, the USA forced Japan to impose voluntary export restraints (VERs) on the exports of cars. VERs resemble import quotas and are, thus limitations on quantity, but are considered self-imposed by the exporting country. Like import quotas, VERs do not bring any revenue to the government but instead quota right holders (companies which have the right to export) acquire quota rents. The USA also practices import quotas on cheese and sugar. The effect of all such tariff and non-tariff barriers is to raise the domestic price of imported goods. The USA has a sophisticated tariff code which uses the term "most favored nation" to put a country on equal grounds with all other trading partners. The "most favored nation" clause does not mean that a given partner is "favored," but, rather, that it will be treated no worse than others. The "most favored nation" status guarantees equal treatment of all trading partners and countries.

It is well known that through the exports multiplier increased exports increase the GDP and the equilibrium interest rate in the country (Keynes 1936). At the same time, a higher inclination for consuming foreign goods affects the trade balance adversely, as it discourages exports, while encouraging imports (Todorova 2022). The negative trade balance of the USA with a number of countries could be due to the fact that Americans prefer foreign goods over domestically produced ones. In the section that follows we analyze the welfare gains of the USA stemming from the imposition of import tariffs on its trading partners. The paper ends with conclusions.

2. Welfare Gains with the Imposition of Tariffs

The standard trade model stipulates that in a static economy, one which does not experience economic growth, the country produces at a point on its production possibility frontier PPF. The point depends on the productive capacity of the economy, the availability and allocation of resources between the sectors of the economy and the particular technology used in production. If the country is a closed economy, *i.e.*, an autarky, it must consume where it produces, that is, on the very production possibilities frontier. For a closed economy, production limits consumption but the point of production on the PPF curve depends on the tastes and preferences of the nation. The country produces of each good as much as the nation demands. However, with free trade the country can consume above its production possibility frontier, on its consumption possibility frontier CPF. This consumption exceeding the productive capacity of the economy is one of the advantages of free trade and a result of the gains from trade. Figure 1 illustrates that the consumption point *C* of the USA is on the CPF, much above the PPF of the country. The production point is *P* on the PPF. At point *C* the USA is on a highest community indifference curve which indicates the particular taste of the nation towards local and imported goods. In the absence of international trade, the nation would have to consume at the point of production *P*.

Figure 1. Consumption and production at particular terms of trade



Source: created by author on the basis of Krugman and Obstfeld (2003)

The relative commodity price $\frac{P_x}{P_y}$ which gives the terms of trade of the USA, *i.e.*, the price of US exports over the price of US imports gives the slope of the isovalue line, where the nation produces the two goods, x and y, that is,

$$P_x Q_x + P_y Q_y = V$$

$$Q_y = \frac{V}{P_y} - \frac{P_x}{P_y} Q_x$$

In equilibrium the terms of trade $\frac{P_x}{P_y}$ also give the ratio of the imports of x over the exports of y, or vice versa, depending on which country is the exporter and which one is the importer. This results from the key macroeconomic identity by which the value of production equals the value of consumption in the absence of foreign borrowing or lending:

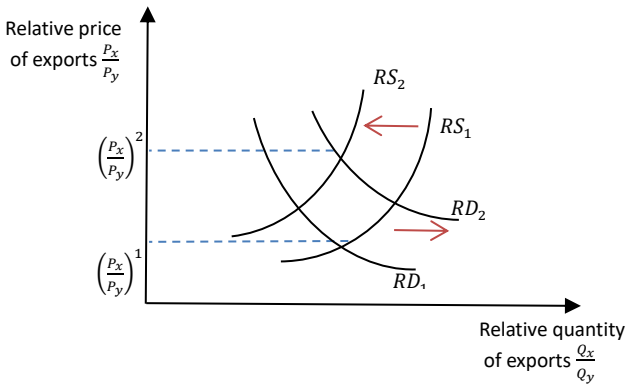
$$P_x Q_x + P_y Q_y = P_x C_x + P_y C_y$$

$\frac{P_x}{P_y} = \frac{C_x - Q_x}{Q_y - C_y} = \frac{imports\ of\ x}{exports\ of\ y}$, or alternatively,

$$\frac{P_x}{P_y} = \frac{Q_x - C_x}{C_y - Q_y} = \frac{exports\ of\ x}{imports\ of\ y}$$

In order for the nation to expand its consumption possibility frontier CPF and reach a higher point of consumption, *i.e.* move to a higher community indifference curve, the nation must produce more. This means that it should achieve growth and experience a shift in its production possibilities frontier PPF. Economic theory stipulates that such an expansion of the PPF is possible for two reasons: 1) the discovery and employment of new factors of production, for instance, inflow of labor, or capital or the discovery of new lands, or 2) an improvement in the existing productive technology. If the economy does not experience growth, the only possibility for increased consumption is the increase in the slope of the isovalue line which sets the CPF. We already stressed that this slope is the relative commodity price, *i.e.*, the value of the country's exports over the value of the country's imports or the terms of trade of the country. If the country manages to raise its terms of trade, thus making its CPF steeper, it could potentially move to a higher indifference curve and consume more without producing more, *i.e.*, staying on the same PPF.

Figure 2. Terms-of-trade effects of an import tariff practiced by a large economy



Source: created by author on the basis of Krugman and Obstfeld (2003)

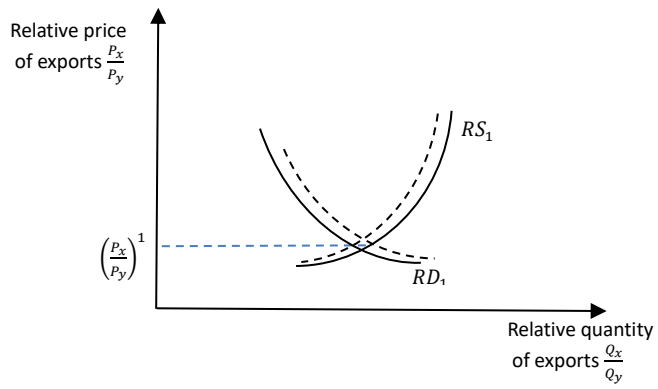
In the absence of growth, the nation can see its terms of trade increasing (the CPF getting steeper) on two premises: 1) the price of its exports P_x increases relative to the price of imports P_y, and 2) the price of imports P_y falls due to, for instance, world growth in the sector of the imported good, y. This growth in the sector of y need not occur in the importing country but in some foreign country which specializes in y, the imported commodities. As mentioned, it does not matter where the growth occurs – if it is in the sector of the imported good y, it potentially improves the terms of trade of the country. As to the price of exports, growth can have an adverse effect of reducing

the price of the country's exports thus worsening its terms of trade. A rise in the price of x can result from an increased world demand for the exported good x. If demand for US goods has not increased much and no essential growth has occurred in the import-competing sector of the USA, the terms of trade of the country have not improved substantially or may have worsened. With static terms of trade, the country whose economy does not grow substantially in its imports-competing sector, cannot improve its consumption position and welfare.

One possibility for the USA to improve its terms of trade is by the imposition of import tariffs which affect negatively the rest of the world but benefit the US economy. If the USA imposes a tariff on its imports, the price of the imports relative to that of the US exports will rise domestically (Figure 2). This will make the locally produced good x for exports relatively cheaper for domestic consumers. Due to the substitution effect domestic consumers switch to the now relatively cheaper domestically produced good x and reduce their consumption of the relatively expensive imported good y. The tariff makes the imported good y more expensive for local consumers. This increases the relative demand for the local (exported) good x in terms of the imported good y shifting the relative demand curve RD for good x in terms of good y to the right. With relative supply RS the effect is the opposite. Due to the higher internal price of the imported good y, local firms which previously produced x for exports now switch to the production of y. There is less x produced in the USA and more y. This reduces the relative supply of x in terms of y shifting the RS curve of x in terms of y to the left. As a result of both comparative-static shifts, the equilibrium relative price of the exported, locally produced good x in terms of that of the imported good y, that is, the terms of trade of the USA, $\frac{P_x}{P_y}$ increases. By imposing a tariff on imports the USA directly improves its terms of trade.

What is possible for a large country to do, is not possible for a small nation. The size of the domestic economy imposing the tariff matters in the effect on the terms of trade (see Figure 3). Since the demand and supply in a small economy are insufficient to influence the world relative demand and supply curves RD and RS, it is impracticable for a small open economy to implement an import tariff. The large economy, at the same time, has a vested interest in changing the world terms of trade to its advantage. Import tariffs can thus turn into an instrument for large nations to reduce the welfare of the rest of world or smaller nations while improving their own welfare.

Figure 3. An import tariff practiced by a small country



Source: the author

The effect of the import tariff on the world terms of trade is just opposite to that of the export subsidy which worsens the terms of trade for the exporting country. It is well known that the EU practices such export subsidies in the agricultural sector along its common agricultural policy CAP[1]. This policy improves the terms of trade of the USA further, not accounting for the US farmers who are affected adversely by European export subsidies and the CAP. While the EU worsens its own terms of trade through export subsidies, the USA pursues a policy of improving terms of trade by practicing import tariffs.

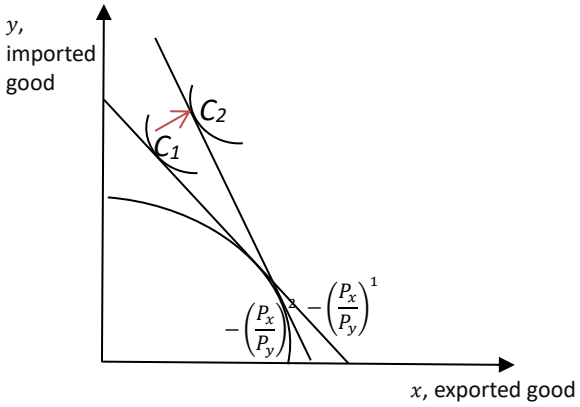
Trump's tariffs put the USA on a higher indifference curve and a higher point of consumption without the need for the nation to generate any additional productive value and to expand its PPF. The USA is aware of its

[1] Since 2023 the CAP has undergone essential changes related to sustainability, environmental preservation and climate change, independent country policies for each member state, support for smaller farms, and performance-based subsidies.

"magnitude," of the size of its economy and the influence it has on the world economy. In Figure 4 the nation whose terms of trade improve moves to a higher indifference curve and a higher point of consumption. From consumption point C_1 it moves to C_2 on a higher indifference curve. The nation does not experience growth or improvements in technology, it suffices to use trade policy instruments such as import restrictions to improve its welfare. The new consumption point C_2 is outside of the production set and much above the PPF of the country.

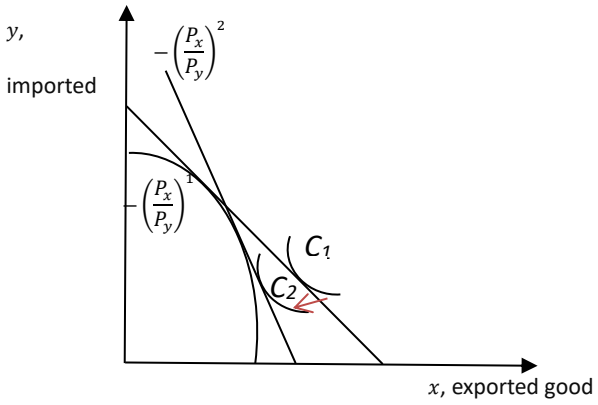
The effect on the rest of the world is the opposite. Because their terms of trade now decline, the countries which are trading partners of the USA move to a worse consumption position on the new isovalue line, which is flatter for them, *i.e.*, the terms of trade are now lower for these countries. This is illustrated in Figure 5. Without substantial effort the USA increases its welfare while managing to reduce that of the rest of the world. An import tariff by the USA can increase its welfare at the expense of its trading partners, or "the rest of the world."

Figure 4. Improved consumption due to improved terms of trade



Source: created by author on the basis of Krugman and Obstfeld (2003)

Figure 5. Worsened consumption for the rest of the world due to improved terms of trade for the USA



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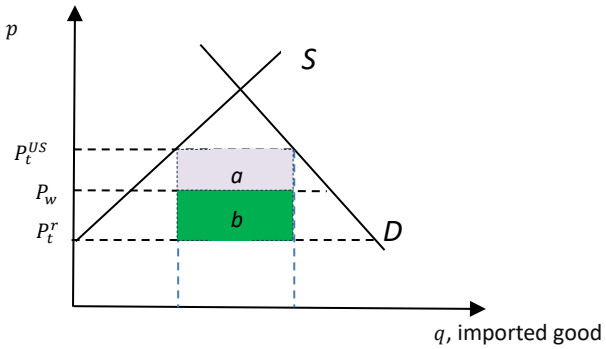
The terms-of-trade gain of the import tariff can further be presented by use of graphical welfare analysis for the imposing country.

Figure 6. Terms-of-trade gains for the large economy due to an import tariff



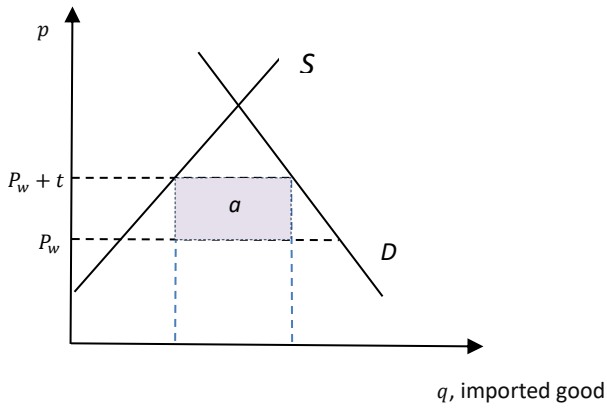
Source: created by the author

As was mentioned, if the nation is a large economy, it can substantially influence the world terms of trade by suppressing the foreign export price, that is, the export price P_y of the rest of the world.

Figure 6 illustrates the cost and benefit analysis of the import tariff for the large economy. Whereas the total tariff revenue to the government includes areas *a* and *b* shaded in the figure, area *b* represents the terms-of-trade gain of the USA which arises because it manages to lower the export price of the imported goods from abroad. The unit tariff rate is $t = P_t^{US} - P_t^r$.

This shows that an import tariff is extremely beneficial for the imposing large economy – it not only collects revenue from it but also achieves substantive terms-of-trade gains. For the small country this is not possible and such terms-of-trade gains do not exist because the country is too small and cannot suppress sufficiently the export price of the importer. Because the small country imposing a tariff cannot affect the world terms of trade, it takes the entire burden of the tariff – an increased internal price of the imported good, dramatically decreased imports and lack of terms-of trade gain (Figure 7). The tariff revenue for the government is area *a,* not accounting for the consumption and production distortion effects of the tariff.

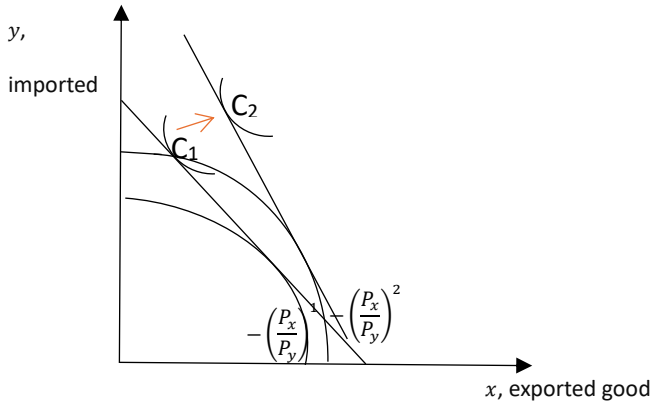
Figure 7. The small country case with an import tariff



Source: the author

So far, we have described what the USA could achieve as a static economy, using the instruments of trade policy to influence the world without experiencing the dynamic effects of growth. To this we now add the figures on real GDP growth presented in the beginning and the fact that the USA has grown since 2021. This can potentially improve the US terms of trade further, especially if the import-competing sectors of the US economy grew more than the export-oriented ones. Figure 8 presents the case of a growing economy which does not experience immiserizing growth, that is, its terms of trade are improving as a result of the growth, not worsening. In this case, the terms of trade improve due to two factors: 1) the actual growth of the economy with a bias toward the imported good y, and 2) the effect of the import tariff imposed on x. Economic growth is likely to be biased, that is, the increase in a factor of production which a particular product is intensive in would affect the production of that product more than the other sector which is not intensive in the respective growing factor of production. An increase in a factor of production would not necessarily benefit all sectors of the economy. The sector whose intensive factor is increasing would expand while the other sectors would shrink to release productive resources and capacity for the growing sector. This again is consistent with the Heckscher-Ohlin model.

Figure 8. Improved terms of trade and the consumption position of a growing economy



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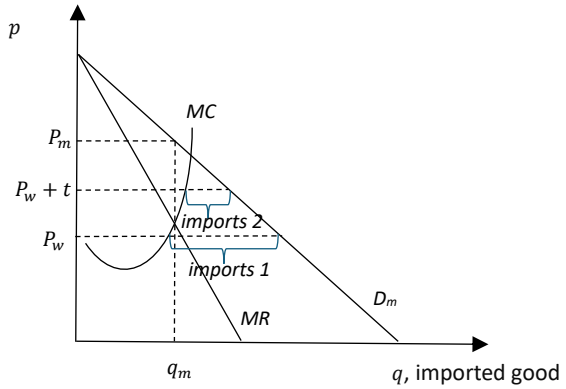
Furthermore, improved technology which expands the PPF of the country may not affect equally both sectors of the economy, the exports and imports. Technology may be more applicable to one of the sectors. In line with Krugman and Obstfeld (2003) we have shown previously that growth is rarely immiserizing: 1) the growing economy should be big enough to affect the world terms of trade, and 2) the relative demand for the product of the expanding industry should be highly inelastic in order for the terms of trade of the growing economy to fall dramatically (Todorova 2010). There are few such products traded in the world economy whose demand is highly inelastic (Todorova 2010). For the USA, which practices import tariffs, the consumption position improves because: 1) there is growth which moves the country to a higher community indifference curve, and 2) tariffs improve the terms of trade of the country which additionally betters the consumption position of the USA. In other words, both developments move the country to a higher community indifference curve and favor the nation.

We can hypothesize that the import tariffs were solicited by monopolies in the USA and could be the result of rent seeking. We already mentioned that the USA imposes import quotas on sugar and cheese from abroad to protect the domestic producers of these two products. Although they protect the local monopolists better than an import tariff, import quotas are extremely restrictive (Todorova and Kalchev 2015). The import quota transforms the consumer surplus into producer surplus for the importing quota rent holder and the domestic monopolist. At the same time, there is no revenue for the government. An import tariff is preferable to society than an import quota and brings revenue to the government while still protecting the monopolist. Figure 9 reveals how an import tariff protects the monopolist along his demand curve. The domestic monopolist would prefer banning foreign trade so that he can serve the entire market demand D_m. At this point his surplus would be maximum with the monopoly price being P_m and the monopoly output being q_m. However, in the conditions of free trade from a pure monopoly the domestic monopolist turns into a perfect competitor. Confronted with the world price P_w which is very low, he now has to take it as given and behave competitively. He produces an output level at $MC = P_w$, while the rest comes from imports. At the world price P_w the amount imported is *imports 1.* Seeking protection, the monopolist requests a tariff to the amount of t which increases the price for him to $P_w + t$. At this new price the monopolist still behaves competitively, setting his marginal cost equal to this new price but his production of the goods increases, while the imports from abroad shrink to *imports 2*. Although the tariff does not bring the monopolist to his monopolist position in the conditions of a closed economy, he still achieves bigger sales and a higher price with the tariff.

Figure 9. Protection of the monopolist by a tariff



Source: the author

Import tariffs do not protect domestic monopolies as well as import quotas (Krugman and Obstfeld 2003; Todorova and Kalchev 2015). However, they still act as a protective measure. In the absence of protectionism, the domestic monopolist behaves as a perfect competitor and takes the world price as given. This is a reason for domestic monopolies request protection from the government. Trump's tariffs favor monopolistic firms in the USA which still behave competitively under the import tariff but the price they take is now higher by the amount of the tariff. This increases their sales as a share of the domestic market against foreign competition and their profits, although not at the monopoly level.

Conclusion

The purpose of Trump's administration in imposing import tariffs is not only to reduce the US trade deficit. It has much broader, welfare effects and repercussions. A large nation can manipulate the world terms of trade to its favor. By imposing import tariffs on the rest of the world the USA can move to a higher community indifference

curve and better consumption position without the need to achieve economic growth. This puts the trading partners of the USA at a disadvantage and on a lower consumption point worsening thus their consumption position. Import tariffs also favor, to some extent, domestic monopolies and could be the result of rent seeking.

Declaration of Competing Interest

The authors declare that they have no known competing financial interests or personal relationships that could have appeared to influence the work reported in this paper.

Declaration of Use of Generative AI and AI-Assisted Technologies

The author declares that she has not used generative AI and AI-assisted technologies during the preparation of this work.

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