An Economic Perspective on the "Reciprocal Tariffs"

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Abstract

This paper considers the economic foundation for the Trump administration's 2025 Executive Order imposing "reciprocal tariffs" under the International Emergency Economic Powers Act (IEEPA). The analysis in the Executive Order rests on numerous historical and economic fallacies, some rather subtle. They undermine each step in the logic of the Executive Order. An understanding of the errors in its logic exposes important flaws in contemporary discourse about U.S. trade and thus has implications that extend well beyond the dispute over the President's powers under IEEPA.

Keywords: IEEPA, reciprocal tariffs, trade deficits, balance of payments, Section 122

JEL Classifications: F13, K33, F5

On April 2, 2025, President Trump issued an Executive Order announcing the imposition of substantial new tariffs on U.S. trading partners following a declaration of a "national emergency" under the International Emergency Economic Powers Act (IEEPA). Pursuant to the declared emergency, the President imposed wide ranging "reciprocal tariffs," consisting of a 10% baseline tariff on imports from all countries with limited exceptions along with additional tariffs ranging as high as 50% for some trading partners. The initial tariffs were later modified to some degree following bilateral negotiations with certain trading partners and in accordance with various exemptions granted by the President.

The President's authority to impose these tariffs under IEEPA was subsequently challenged by various private plaintiffs and state attorneys general. The plaintiffs were successful before the Court of International Trade (CIT),[1] the District Court of D.C.,[2] the Court of Appeals for the Federal Circuit,[3] and ultimately the Supreme Court.[4] In a 6-3 ruling, the Court held that the power to "regulate…importation" under IEEPA did not include the power to impose tariffs, or at least did not delegate authority to impose tariffs clearly enough to satisfy the "major questions" doctrine.[5]

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[1] V.O.S. Selections, Inc. v. United States, CIT slip op. 25-66, May 28, 2025.
[2] Learning Resources, Inc. v. Trump, D.D.C. slip op. in Civil Action 25-1248, May 29, 2025.
[3] V.O.S. Selections v. Trump, Fed. Cir. Slip op. in case no. 25-1812, August 29, 2025.
[4] Learning Resources, Inc. v. Trump, Docket No. 24-1287, 607 U.S. _ (2026).
[5] Three members of the majority (Justices Jackson, Kagan and Sotomayor) found that tariff authority was clearly lacking under the language of the statute, while the other three members of the majority (Chief Justice Roberts

We believe the Court reached the correct outcome in striking down the IEEPA tariffs and have little to add on the statutory construction and quasi-constitutional issues that drove the Court's ruling. Instead, we focus on the economic foundation for the reciprocal tariffs as set forth in the Executive Order announcing the tariffs. The Order is replete with historical and conceptual errors that undermine each step in its rationale for the tariffs. Some of these errors are subtle, such as the endogeneity of trade balances, the meaning of "reciprocity" in international trade, the relation between the balance of payments and the balance of trade, and the implications of new foreign investment commitments for the trade balance. By clarifying these and other issues, we offer more general lessons for trade policy formulation and expose popular fallacies that have infused recent trade policy discourse in Washington.[6]

I. The Foundation for "Reciprocal Tariffs" in the Executive Order

The International Emergency Powers Act (IEEPA) empowers the President to employ a broad range of measures "to deal with any unusual and extraordinary threat, which has its source in whole or substantial part outside the United States, to the national security, foreign policy, or economy of the United States." Measures cannot be taken under IEEPA unless the President declares a national emergency under the National Emergencies Act.[7]

This authority was invoked by President Trump in the Executive Order of April 2, 2025,[8] which states:

> *Large and persistent annual U.S. goods trade deficits have led to the hollowing out of our manufacturing base; inhibited our ability to scale advanced domestic manufacturing capacity; undermined critical supply chains; and rendered our defense-industrial base dependent on foreign adversaries. Large and persistent annual U.S. goods trade deficits are caused in substantial part by a lack of reciprocity in our bilateral trade relationships. This situation is evidenced by disparate tariff rates and non-tariff barriers that make it harder for U.S. manufacturers to sell their products in foreign markets. It is also evidenced by the economic policies of key U.S. trading partners insofar as they suppress domestic wages and consumption, and thereby*

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and Justices Barrett and Gorsuch) concluded that clear authority to impose the sweeping reciprocal tariffs was lacking, rendering the President's assertion of tariff authority impermissible under the "major questions" doctrine.

[6] Although the tariffs have substantial implications for other nations, our emphasis is on the domestic case for tariffs put forward by the Trump administration. We also do not focus in this paper on the revenue implications of tariffs, as we believe that tariffs are a comparatively inefficient way to raise government revenue, and nothing in the President's Executive Order suggests that they are being imposed because of some fiscal "emergency." Likewise, we do not focus on whether tariffs might be rationalized as an effort to pursue an "optimum tariff" that exploits U.S. market power over import prices to improve the U.S. terms of trade. Once again, that objective bears no apparent connection to the declared "emergency."

[7] 50 U.S.C. §1601 et. seq.

[8] Regulating Imports with a Reciprocal Tariff to Rectify Trade Practices that Contribute to Large and Persistent Annual United States Goods Trade Deficits, available at https://www.whitehouse.gov/presidential-actions/2025/04/regulating-imports-with-a-reciprocal-tariff-to-rectify-trade-practices-that-contribute-to-large-and-persistent-annual-united-states-goods-trade-deficits/.

demand for U.S. exports, while artificially increasing the competitiveness of their goods in global markets.

The Order later recites: "I have declared a national emergency arising from conditions reflected in large and persistent annual U.S. goods trade deficits, which have grown over 40 percent in the past 5 years alone, reaching $1.2 trillion in 2024."

Tracing the logic of these recitations, ostensible problems in the manufacturing sector have their origin "in substantial part" with a lack of reciprocity in bilateral trading relations between the United States and the rest of the world. The result has been "large and persistent annual U.S. goods trade deficits," which have "grown over 40% in the last 5 years alone." These deficits in turn have "led to" a "hollowing out" of the manufacturing base, difficulties in "scaling" manufacturing capacity, harm to "critical supply chains," and a defense industrial base "dependent on foreign adversaries." Later, the Order states that the decline in manufacturing capacity has led to a "loss of manufacturing jobs." The Order thereby posits the existence of a causal chain that runs from a lack of reciprocity, to merchandise trade deficits, and finally to various problems in the manufacturing sector.

In the remainder of this paper, we engage with each part of this argument. We contest the claim that trade deficits have grown dramatically of late, and the claim that a lack of "reciprocity" is responsible for the modest growth that has occurred. We explain why trade deficits occur and why they are endogenous and are not the "cause" of conditions in the manufacturing sector. We next discuss how the use of tariffs to curtail merchandise trade deficits can harm the manufacturing sector as well the services sector. We explain why the administration's efforts to attract inbound foreign investment is squarely at odds with the claim that the stated goal of reducing merchandise trade deficits. Finally, the reciprocal tariffs amount to little more than a randomized tax on all merchandise imports from all foreign sources, which could address any *bona fide* emergency conditions in the manufacturing sector only by coincidence.

II. The Growth of the Merchandise Trade Deficit and its Relation to Reciprocity in Bilateral Trade Relations

The Executive Order characterizes the merchandise trade deficit as a rapidly burgeoning problem, increasing "40% in the last 5 years alone." This claim is highly misleading. Focusing on the past five years of available data (as does the Executive Order), it is true that the merchandise trade deficit in nominal dollars rose 41.8% from 2019 to 2024.[9] Over the same period, however, the consumer price index rose 22.7%[10] and the producer

[9] Merchandise trade deficit data available at https://www.bea.gov/data/intl-trade-investment/international-trade-goods-and-services.

[10] Consumer price index data available at https://www.minneapolisfed.org/about-us/monetary-policy/inflation-calculator/consumer-price-index-1913-.

price index for all manufacturing rose nearly 26%,[11] indicating that roughly half of the nominal growth in the deficit was due to inflation.

Much of the further increase can be attributed to the growth of the economy. Using the same data sources, the ratio of the merchandise trade deficit to GDP was 3.98% in 2019, and 4.16% in 2024, a percentage increase of only 4.5% over five years. And taking a broader historical perspective, the merchandise trade deficit was at a maximum relative to the size of the U.S. economy two decades ago in 2006, when it reached 5.7% of GDP.[12] Even if one embraces the notion that merchandise trade deficits are somehow a "problem" – a notion that we contest below – they have not changed much of late in relation to the size of the economy.

Putting that point to the side, the President's Executive order recites that "goods trade deficits are caused in substantial part by a lack of reciprocity in our bilateral trade relationships. This situation is evidenced by disparate tariff rates and non-tariff barriers that make it harder for U.S. manufacturers to sell their products in foreign markets." The Executive Order also states that "the trading relationship between the United States and its trading partners has become highly unbalanced, particularly in recent years." On numerous occasions, the President has gone farther to suggest that our trading partners are "ripping us off.[13]"

On the premise that bilateral deficits reflect a denial of reciprocity to the United States, the United States Trade Representative (USTR) calculated the "reciprocal" tariffs announced on April 2 by asking the following question -- what increase in the average tariff rate on goods from each country that runs a merchandise trade surplus with the United States will cause its exports to the United States to decline by an amount sufficient to balance bilateral merchandise trade?[14] Based on a number of (questionable) assumptions,[15] the analysis yielded a formula implying that the requisite average tariff

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[11] Producer price index data available at https://fred.stlouisfed.org/series/PCUOMFGOMFG.

[12] GDP data available at https://fred.stlouisfed.org/series/GDP.

[13] See ABC News, They're Ripping Us Off: Trump's Longstanding Grievance Driving His Risky Tariffs, available at https://abcnews.go.com/Politics/theyre-ripping-us-off-trumps-long-standing-grievance/story?id=120447216.

[14] See the USTR fact sheet, available at https://ustr.gov/sites/default/files/files/Issue_Areas/Presidential%20Tariff%20Action/Reciprocal%20Tariff%20Calculations.pdf.

[15] The calculation assumed that the price elasticity of demand for imports is 4 from every country, only 25% of any tariff passes through to the buyers of imports, exchange rates are unaffected by tariffs, foreign governments do not retaliate following new tariffs, and nothing else happens that would cause U.S. exports to decline. It further ignored the fact that a higher tariff on imports from one country might divert U.S. purchases to a third country, thereby worsening the bilateral deficit with that country.

All these issues raise serious questions about the tariff calculations. To take one example, if USTR had assumed that the pass through of tariffs to importers is close to 100%, in keeping with the empirical evidence in the literature, their calculations would have generated tariffs only one-fourth as large. See Mary Amiti, Stephen J. Redding & David E. Weinstein, The Impact of the 2018 Tariffs on Prices and Welfare, 33 J. Econ. Persp. 187 (2019).

increase on goods from each country was equal to the ratio of the bilateral trade deficit to the initial quantity of (bilateral) U.S. imports. (For countries with which the United States ran a trade surplus, an arbitrary 10% tariff was applied.). The result of this calculation was a set of highly discriminatory tariffs, with their magnitude tied to the proportionate size of the bilateral deficit. This section examines the underlying premise of this reciprocal tariff calculation – that a bilateral trade deficit reflects a lack of "reciprocity" in bilateral trading relations.

The Executive Order does not offer a precise definition of "reciprocity," but implies that the concept involves a comparison between barriers to U.S. exports abroad and barriers to U.S. imports. The "evidence" that barriers to U.S. exports are greater than the barriers to U.S. imports has three components -- the existence of bilateral and aggregate U.S. manufacturing trade deficits, disparities in average tariff rates between the United States and certain other countries, and a recitation that trading partners have created various "non-tariff barriers" to U.S. exports. We consider each of these points in turn, and then discuss the meaning of "reciprocity" in economics and link it to its meaning historically in the WTO/GATT system. Our punchline is that the trading system is not infused with a general lack of reciprocity toward the United States in any meaningful sense of the term, although certain developing economies do have higher tariffs because they have not been asked to make as many trade concessions through the years as the developed economies. Even if this asymmetry can be deemed a lack of reciprocity, however, it is not manifest in bilateral trade deficits and cannot logically support the administration's approach to its "reciprocal tariffs."

We begin with the question whether trade deficits themselves evidence a lack of reciprocity. To the contrary, bilateral trade between countries is no more likely to be balanced than bilateral trade among individual economic actors. Most of us run trade surpluses with our employers and trade deficits with our grocers, yet no one imagines these relationships to be unfair or non-reciprocal. International trade allows countries to specialize in what they do best in comparative terms. There is no reason to expect that the countries demanding a lot of what the United States exports will be the same ones that supply a lot of what the United States imports.

Much the same thing can be said about the significance of aggregate trade deficits in merchandise trade. As we discuss further in Section IV, the merchandise trade deficit is driven largely by an imbalance between national savings and investment, not by barriers to U.S. exports.

The Executive Order also purports to demonstrate an absence of reciprocity by pointing to tariff disparities on individual items, such as a lower tariff historically on automobile imports into the United States than on U.S. auto exports to Europe and certain other countries. These anecdotal comparisons are unhelpful, however, as one can readily find anecdotal examples where U.S. tariffs and trade restrictions are higher on individual items. U.S. sugar tariffs and quotas, for example, lead to sugar prices roughly twice as high

as those on world markets, a situation that has persisted for many years.[16] The United States has also long imposed a higher tariff on light duty trucks (25%) than trading partners, dating back to the "chicken war" of the 1960s that arose following European tariffs on U.S. chicken exports. The growth and popularity of the SUV segment of the auto industry in the United States is often attributed to this 60-year period of special protection for light truck producers.

The Executive Order further points to the United States having lower "simple average tariff rates" than various trading partners. Average tariff rates, however, are potentially misleading as well. A "simple average" does not consider the commercial importance of the tariff – for example, a tariff might be high on a product that a country would not import to any extent even with a low tariff. Trade-weighted average tariff rates address this issue to a degree but can also mislead. A prohibitively high tariff that chokes off trade in a product will receive little or no weight in the average because the volume of trade is negligible due to the tariff. Even with these caveats, the differences in the average tariff rates across developed country trading partners tend to be small. WTO data on average applied tariff rates for 2024 indicate that the average rate for Australia was 2.4%, for Canada 3.81%, for Japan 3.9%, for the European Union 5.1%, and for the United States 3.4%.[17] In sum, anecdotal tariff differences on individual products or average tariff computations are not convincing evidence of a general lack of "reciprocity" toward the United States.

To be sure, the history of the GATT/WTO system does reflect "special and differential treatment" for developing countries.[18] These policies were devised in the hope that they would promote development and contribute to reducing poverty in the developing world. Related, many developing countries were not asked for tariff concessions during trade negotiations to the same degree as developed economies because their markets were unimportant at the time. Some of these developing countries have become much more important players in the world economy in the intervening years and may now be perceived to have been "free riders" to an extent on historical tariff concessions by the developed economies. The President's Executive Order notes that average tariff rates for some of these countries are materially higher than average rates for the United States – India at 17%, for example, and Brazil at 11.2%. But any attendant absence of "reciprocity" due to special and differential treatment was a product of U.S. policies that supported such treatment and is not systematically reflected in the bilateral merchandise trade balance. To take the example of Brazil, the United States has had a merchandise trade surplus with Brazil every year since 2007.[19] Moreover, the administration's reciprocal tariffs were plainly not targeted in any systematic way at the historical beneficiaries of special and differential treatment or at developing country "free riders."

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[16] See https://sweetenerusers.org/wp-content/uploads/2024/08/SUA-White-Paper-on-U.S.-Sugar-Prices-UPDATED-FINAL-2.pdf.

[17] Available at https://ttd.wto.org/en.

[18] The associated tariff preferences are embodied in the "Generalized System of Preferences," which was approved by the GATT membership as an exception to the MFN obligation.

[19] See U.S. Census Bureau, Trade in Goods with Brazil, available at https://www.census.gov/foreign-trade/balance/c3510.html.

The final component of the evidence for a lack of reciprocity in the Executive Order relates to non-tariff barriers. The Order points to a long list of concerns such as import licensing regimes, regulatory barriers, intellectual property policies, corruption, and low ratios of consumption to GDP in certain countries. To the degree that these concerns can meaningfully be seen as trade "barriers" (as opposed to, for example, a reflection of national savings rates that have little to do with trade), the discussion is striking for its failure to recognize the fact that U.S. trading partners have many complaints about non-tariff barriers in the United States.[20] A mere recitation of U.S. concerns about non-tariff barriers abroad does not establish that U.S. barriers are smaller or less significant. Likewise, many of the enumerated non-tariff barriers fall squarely under existing WTO agreements pertaining to import licensing, sanitary and phytosanitary measures, technical barriers to trade, trade-related aspects of intellectual property rights, subsidies and countervailing measures, and trade in services. The Executive Order does not explain why the United States has resorted to unliterally imposed "reciprocal tariffs" rather than pursuing its right to seek redress for non-tariff barriers under existing international rules. And if the reason is that the "barriers" identified by the United States are perfectly permissible under existing rules, one can question whether they are properly deemed barriers at all.

We conclude this section with some remarks about the concept of "reciprocity" in economics and in the WTO/GATT system historically. Economic theory offers an interpretation of reciprocity based on the effects of trade agreements on the terms of trade – the relative prices of a nation's imports and exports at the border. Agreements that reduce the price that nationals receive from foreign customers for exports relative to what they pay foreign suppliers for their imports worsen the terms of trade and reduce national income, other things being equal, because what the nation sells has become relatively cheaper and what it buys has become relatively more expensive. Agreements that improve the terms of trade have the opposite effect. "Reciprocity" in an economic sense occurs when trade agreements open markets in both directions while leaving the terms of trade unchanged. A considerable body of theoretical work establishes that tariff negotiations in accordance with the reciprocity norm of GATT will preserve the terms of trade and achieve reciprocity in an economic sense.[21]

The norm of reciprocity in trade negotiations has its origins in U.S. trade policy following the U.S. (Smoot-Hawley) Tariff Act of 1930 and the ensuing trade wars during the Great Depression. To address the attendant disruption in international trade, Congress passed the Reciprocal Trade Agreements Act of 1934 authorizing the President to negotiate mutual tariff reduction agreements with foreign governments. The notion of reciprocity introduced by the 1934 Act later became central to multilateral trade negotiations under the

[20] Examples of U.S. policies that have been challenged under the law of the WTO or U.S. free trade agreements include sugar quotas, cotton subsidies, country of original labeling requirements, tuna labeling requirements, prohibitions on non-menthol cigarette flavorings, customs user fees, restrictions on shrimp imports, and numerous others.

[21] See Kyle Bagwell & Robert W. Staiger, An Economic Theory of GATT, 89 Am. Econ. Rev. 215 (1999).

auspices of GATT and its successor the WTO. From the outset of GATT, negotiators understood "reciprocity" to refer to a balance of trade concessions that would allow each country to increase its *aggregate* exports to other GATT members by an amount approximately equal to the increase in its aggregate imports from those members.[22] This approach allowed each member country to seek improved market access for its exports of greatest importance, whether economically or politically. Negotiators took this reciprocity norm seriously – the U.S. State Department, for example, made calculations during the rounds of tariff negotiations under GATT to confirm that aggregate U.S. exports could be expected to increase due to tariff cuts abroad by an extent roughly equal to the increase in U.S. imports expected to result from U.S. tariff cuts.[23] At no point did reciprocity imply that each party would have identical tariff rates on individual goods. Likewise, reciprocity at no time was taken to mean that bilateral trade would balance or that bilateral trade opportunities would expand equally.[24]

This commitment to reciprocity throughout the history of multilateral trade negotiations is in tension with the claim in the Executive Order that the trading relationship between the United States and its trading partners has "become highly unbalanced, particularly in recent years." It instead suggests that any asymmetry in market access opportunities arose years ago. Those asymmetries may have been preserved by trade negotiations grounded in the norm of reciprocity, but not exacerbated by them.[25]

Even where reciprocity exists in trading relations, of course, it does not follow that all manufacturing industries or other industries affected by trade will thrive. Trade liberalization creates winners and losers – winners in the form of exporters and consumers, losers in the form of import-competing industries, which may well lie in the manufacturing sector. But difficulties in import-competing industries bear no systematic relationship to a lack of reciprocity.

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[22] See Kyle Bagwell & Robert W. Staiger, The Economics of the World Trading System (2002), ch. 1.

[23] See Kyle Bagwell, Robert W. Staiger & Ali Yurokoglu, Multilateral Tariff Bargaining: A First Look at the GATT Bargaining Records, 12 Am. Econ. J.: Applied Econ. 72 (2020).

[24] Although tariff bargains were expected to be "reciprocal" in the above sense, GATT members recognized that the expectations of negotiators regarding the resulting volume of imports and exports might prove mistaken *ex post*. For that reason, trade agreements such as GATT from the outset contained provisions to facilitate the renegotiation of tariff commitments (GATT Article XXVIII), to authorize "safeguards" allowing members to revoke tariff concessions in response to unexpected import surges (GATT Article XIX), and to bring disputes based on a frustration of reasonable expectations for market access (GATT Article XXIII). These provisions facilitated adjustment of the bargain *ex post* in response to economically or politically problematic developments in individual industries.

[25] One recent study concludes that bilateral current account imbalances (as opposed to merchandise trade imbalances) are caused in substantial part by asymmetries in trade barriers between countries. See Alejandro Cuñat & Robert Zymek, Bilateral Trade Imbalances, 91 Rev. Econ. Stud. 1537 (2024). If correct, this finding does not undermine the proposition that tariff negotiations delivered reciprocity as to the expected change in aggregate exports and imports for each country. It simply suggests that the starting point for the exchange of tariff concessions may have been asymmetric – reciprocity in negotiations expanded trade in reciprocal fashion but did not eliminate pre-existing asymmetries in trade impediments. Any asymmetries that persist today may thus date back many years, and do not suggest any newly exigent circumstances.

III. Merchandise Trade Deficits: Cause and Effect

Because bilateral and aggregate merchandise trade deficits do not reflect an absence of reciprocity in trading relations, the administration's calculation of "reciprocal" tariff rates based on bilateral deficits is economically unfounded.[26] We now turn to the next step in the reasoning of the Executive Order – the proposition that merchandise trade deficits, whether aggregate or bilateral, have "led to" the difficulties in the U.S. manufacturing sector.

Economics (as well as other fields such as Philosophy) distinguishes between "exogenous" and "endogenous" variables, also often termed "causes" and "effects." To elaborate, consider the basic supply and demand diagram for a competitive market. The intersection of the supply and demand curves determines the equilibrium price in the market and the equilibrium quantity purchased at that price by buyers. Price does not "cause" quantity and quantity does not "cause" price, they are simultaneously determined by the underlying factors that determine industry supply and consumer demand. Those factors include production technology and input costs (on the supply side) as well as consumer tastes and income (on the demand side). The underlying factors may be viewed as "exogenous," such that a change in one of them will affect either demand or supply and lead to a new equilibrium price and quantity. Equilibrium price and quantity are thus endogenous variables -- they are the "effects" of the underlying determinants of supply and demand.

Merchandise trade deficits too are endogenous -- they are simultaneously determined with other things, including manufacturing output and employment. To illustrate, an increase in foreign demand for products manufactured in the United States due to shifting tastes or rising incomes abroad will, other things being equal, lead to more U.S. exports and greater U.S. production and employment by exporting firms, with a concurrent decline in any merchandise trade imbalance. An extended strike in a U.S. manufacturing industry can lead to more imports of substitute goods to replace domestic production, with a concurrent increase in the merchandise trade deficit and diminished domestic employment. In each of these examples, the changing merchandise trade deficit is an "effect" not a "cause." The causal variables are the factors that affect foreign demand in the first case, and the labor strike in the second case.

It is thus erroneous to claim that trade deficits "cause" or have "led to" whatever difficulties in the manufacturing sector serve as the predicate for the purported "emergency," just as it would be erroneous to claim that difficulties in the manufacturing sector have "led

[26] Following the announcement of the reciprocal tariffs, some observers speculated that the true goal of the administration was to use tariffs as negotiating leverage to open foreign markets to U.S. exports. On that theory, higher tariffs on countries with which the United States has a larger bilateral merchandise trade deficit might be seen as generating more negotiating leverage with the countries that have more to lose in a tariff war with the United States. Of course, if that account captures the true underlying logic of the tariffs, the purported import-related emergency in the U.S. manufacturing sector was pure pretense.

to" increased merchandise trade deficits. Both are a result of other factors. The only "other factor" mentioned in the Executive Order is an asserted lack of reciprocity in bilateral trading relations, but we have already demonstrated that the claimed lack of reciprocity has little foundation, and in any event bears no systematic relation to merchandise trade deficits. In these respects, the causal reasoning of the Executive Order, and its emphasis on the consequences of trade deficits, is economically incoherent.[27] Accordingly, from our economic perspective, we fail to see how the Executive Order identified an "unusual and extraordinary threat" originating abroad -- a statutory requirement for action pursuant to IEEPA.

IV. The Effects of Tariffs on the Balance of Merchandise Trade, Services Trade, and Investment

In announcing the reciprocal tariffs, the Executive Order states: "It is the policy of the United States to rebalance global trade flows by imposing an additional ad valorem duty on all imports from all trading partners except as otherwise provided herein." Although we have questioned the causal connection between the merchandise trade deficit and any worrisome conditions in the U.S. manufacturing sector, this section takes the Order at face value and assumes that the goal of the reciprocal tariffs is to "rebalance" merchandise trade. We thus begin by considering the extent to which the reciprocal tariffs may be expected to reduce the merchandise trade deficit. We then comment on the difference between a balance of payments deficit and a balance of trade deficit, and its implications for the use of tariffs under Section 122 of the Trade Act of 1974. We conclude by discussing potentially worrisome collateral effects of reducing the merchandise trade deficit through tariffs.

A. The Effect of Reciprocal Tariffs on the Merchandise Trade Balance

Other things being equal, tariffs tend to reduce imports and reduce the merchandise trade deficit. For a variety of reasons, however, other factors may dampen this effect, perhaps substantially, and might conceivably reverse it.

First, many of the administration's tariffs fall on intermediate goods (such as steel, aluminum and auto parts). Intermediate goods tariffs raise costs for downstream U.S. manufacturers and damage their competitive position relative to imports, potentially leading to an increase in downstream imports unless downstream tariffs avert the increase. Evidence of this problem has already emerged in the form of substantial profit reductions for

[27] One exogenous factor related to U.S. trade deficits is foreign demand for savings. An increase in savings abroad can lower borrowing rates for the United States and make it cheaper to finance trade deficits with inbound foreign investment (see the discussion in the next section), leading to a larger trade deficit. In a recent paper, the authors find that a "foreign savings glut" has contributed to a larger U.S. trade deficit, and that its contribution could explain roughly 15 percent of the decline in U.S. manufacturing jobs from 1992-2012. The remaining decline was attributed to other factors, primarily growth in manufacturing productivity (as through automation). See Timothy J. Kehoe, Kim J. Ruhl & Joseph B. Steinberg, Global Imbalances and Structural Change in the United States, 126 J. Pol. Econ. 761 (2018).

certain downstream firms.[28] Depending on the relative labor intensity of downstream and upstream production, intermediate goods tariffs can cause a net loss of manufacturing jobs as some recent studies have documented in relation to tariffs imposed during the first Trump administration.[29] Moreover, tariffs on intermediate goods that are used to produce U.S. exports will reduce the competitiveness of those exports, harm exporting firms,[30] and increase the merchandise trade deficit, other things being equal.

Second, the reciprocal tariffs announced in April 2025 were highly discriminatory. Discriminatory tariffs will lead to a rearrangement of suppliers, with U.S. importers shifting to those benefitting from lower tariffs. U.S. merchandise trade deficits may decline with the countries subject to higher tariffs, only to be replaced in significant part by new or larger bilateral deficits with countries that enjoy lower tariffs. Evidence of such shifts has emerged, particularly in regard to China, where U.S. supply chains have reduced their reliance on Chinese goods and shifted toward alternative suppliers such as Vietnam and Mexico.[31] By June 2024, Apple Inc., for example, had expanded its number of vendors in Vietnam to 35, with analysts forecasting that these suppliers would be responsible for producing 20 percent of all iPads and Apple Watches, 5 percent of MacBooks, and 65 percent of AirPods in 2025.[32]

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[28] General Motors, for example, has indicated that it expects a $4-5 billion dollar reduction in profits this fiscal year because of tariffs on input products, including auto parts. See Forbes, GM: Tariffs Cost Automaker $1.1 billion Last Quarter, available at https://www.forbes.com/sites/zacharyfolk/2025/07/22/gm-tariffs-cost-automaker-11-billion-last-quarter/. In the aggregate, U.S. Imports of Automotive Vehicles actually *rose* on a seasonally adjusted basis from 33,196 million In April 2025 to $33,512 in December 2025; see U.S. Census FT-900, available at https://www.census.gov/foreign-trade/statistics/historical/seas.html.

[29] See Aaron Flaaen & Justin Pierce, Disentangling the Effects of the 2018-2019 Tariffs on a Globally Connected U.S. Manufacturing Sector (mimeo January 25, 2024), available at http://www.justinrpierce.com/index_files/flaaen_pierce_tariffs_manufacturing.pdf.

Prior administrations have recognized this danger. During the Reagan administration, the U.S. copper mining and refining industry sought protective tariffs under Section 201 of the Trade Act of 1974, which provides temporary protection for industries "seriously injured" by import competition. The U.S. International Trade Commission recommended tariffs or quotas to assist the industry, but the President declined to impose them, following a campaign by downstream firms to demonstrate that job losses in firms making products such as copper wire and brass would exceed job gains in raw copper production. See Letter to the Speaker of the House and the President of the Senate on the Denial of Import Relief for the Copper Industry, September 6, 1984, available at https://www.reaganlibrary.gov/archives/speech/letter-speaker-house-and-president-senate-denial-import-relief-copper-industry#:~:text=the%20Copper%20Industry-,Letter%20to%20the%20Speaker%20of%20the%20House%20and%20the%20President,highly%20dependent%20on%20copper%20exports.

[30] See Kyle Handley, Fariha Kamal & Ryan Monarch, Rising Import Tariffs, Falling Export Growth: When Modern Supply Chains Meet Old-Style Protectionism, 17 Am. Econ. J: Applied Econ. 208 (2025).

[31] See Laura Alfaro & Davin Chor, Global Supply Chains: The Looming "Great Reallocation" (mimeo August 30, 2023), available at https://drive.google.com/file/d/1KYqW0IrWLEyXnu39hKxDGoxQY18-CNZ9/view; Pablo Fajgelbaum, Penelopi Goldberg, Patrick Kennedy, Amit Khandelwal & Daria Taglioni, The U.S. China Trade War and Global Reallocations, 6 Am. Econ. Rev.: Insights 295 (2024).

[32] See "Apple's Production Strategy in Vietnam," available at https://www.vietnam-briefing.com/news/apples-production-strategy-in-vietnam.html.

Third, foreign retaliation, if it arises, will also lower exports. The experience of the 1930s following the Smoot Hawley Tariff highlights the potential for sizeable retaliatory responses abroad. More recent experience with China, and its retaliatory responses to U.S. tariffs, also underscores the threat of retaliation. China's decision to reduce imports of U.S. soybeans has led to talk of a $10 billion bailout for U.S. soybean producers,[33] and the recent announcement of new export restrictions on rare earth minerals threatens critical supply problems for many U.S. manufacturing industries.[34]

Finally, tariffs reduce the demand for foreign currency to buy imports and typically induce some degree of domestic currency appreciation[35] relative to the exchange rates that would prevail otherwise. Any appreciation of the U.S. dollar will lead to fewer U.S. exports as they become more expensive for foreign purchasers and will reduce the price of U.S. imports in dollar terms potentially offsetting some of the effects of the tariffs on U.S. import prices. Both effects moderate the effects of the tariffs on the merchandise trade balance.

This list of potentially offsetting factors is not exhaustive, as it omits (for example) the possibility that tariffs may have collateral effects in asset markets that can affect trade. The question of how and why tariffs may impact trade deficits has in fact become something of a cottage industry among economists of late, with a growing number of theoretical[36] and empirical contributions.[37]

In sum, we expect that the reciprocal tariffs will have *some* impact in reducing the aggregate merchandise trade deficit, but other factors can diminish their impact considerably and it is difficult to predict how much "rebalancing" will ultimately result. We would also be remiss not to note that eliminating the aggregate merchandise trade deficit

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[33] See Trump Considers $10 billion Bailout for Farmers as Tariffs Disrupt the Market, October 7, 2025, available at https://www.pbs.org/newshour/show/trump-considers-10-billion-bailout-for-farmers-as-tariffs-disrupt-the-market.

[34] See New York Times, Cars to Fighter Jets: China's New Export Curbs May Level a Heavy Blow Worldwide, October 12, 2025, available at https://www.nytimes.com/2025/10/12/business/china-rare-earth-export-controls.html.

[35] The dollar did not appreciate in absolute terms in response to the reciprocal tariffs, apparently because administration policies (including its fiscal policies) have created uncertainty about the future stability of the dollar, thereby causing foreign investors to sell dollar denominated assets. The long-term picture is unclear, but it remains possible that continuing high tariffs will eventually lead to dollar appreciation. Further, as noted in the text, the tariffs may have caused the value of the dollar to be higher than it would have been otherwise, thus reducing U.S. exports relative to the level that would have otherwise prevailed.

[36] See, e.g., Arnaud Costinot & Ivan Werning, How Tariffs Affect Trade Deficits (NBER Working Paper 33709 June 2025) (deriving theoretical conditions under which permanent tariff increases may increase, reduce, or leave unaffected the trade deficit in goods and services).

[37] See, e.g., Lorenzo Caliendo, Samuel Kortum & Fernando Parro, Tariffs and Trade Deficits (mimeo June 13, 2025) (finding that recent U.S. tariffs, particularly against China, have reduced the U.S. trade deficit in goods and services while lowering aggregate U.S. economic welfare); available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=5350334.

through tariffs will lead to a reduction in the national income of the United States due to the familiar deadweight costs of trade protectionism.[38]

B. The Balance of Payments, the Balance of Trade and the Collateral Effects of "Rebalancing"

To understand the points made below regarding the collateral effects of "rebalancing" merchandise trade, we begin with a brief digression on the balance of payments accounts.

1. The Balance of Payments Accounts

The balance of payments accounts are an accounting construct built on double entry bookkeeping. As suggested by the title, they track "payments" between the United States and other countries. For example, consider how the double entry bookkeeping system functions for a typical U.S. import transaction involving $1,000 worth of goods. The U.S. buyer makes a wire transfer drawn on a U.S. bank to the foreign seller for $1,000, resulting in a debit for the United States (a net outflow of money). The foreign recipient of the wire transfer thereby acquires a $1,000 claim on a U.S. bank, which will be recorded as a credit. The bank's liability to the foreign seller may be thought of as a "credit" (inflow of money) because it is analogous to a bank deposit that generates a future claim on the bank owed to a foreign entity. Merchandise export transactions simply reverse the role of these offsetting debits and credits.

Because debits in the balance of payments account are always offset by equal credits elsewhere in the accounts, the balance of payments is always in balance. The foundation for this statement is not an empirical claim but an accounting identity.[39] Economists nevertheless refer at times to balance of payments deficits -- the next section will explain what they mean by that term.

The balance of payments accounts are divided into three components – the current account, the financial account, and the capital account. The current account reflects current period transactions in goods and services, net income earned abroad during the period, and net transfers abroad (such as foreign aid and family remittances). The bulk of the current account is comprised of transactions in goods and services, and it is these transactions that place a country into a trade surplus or deficit. If the aggregate imports of goods and services during the current period exceed the aggregate value of exports, the country has a "balance of trade deficit," while a "surplus" arises when exports exceed imports. Further, because goods and services transactions constitute the bulk of the current

[38] See Id.

[39] In practice, data for the balance of payments accounts are imperfect, resulting in a modest "imbalance" due to a "statistical discrepancy."

account, a trade deficit or surplus will generally imply a current account deficit or surplus as well.

Within the current account, one can further distinguish the balance of services trade and the balance of merchandise trade. In recent years, the United States has run a persistent deficit in goods ("merchandise trade"), and a persistent surplus in services trade.[40]

The financial account and the capital account together record transfers of financial and other capital assets and liabilities, such as transactions in stocks, bonds, business investments, sale of assets such as land, and so on. The details of what is recorded in the capital account versus the financial account need not detain us, but one can think of the combined balance in these accounts as the obverse of the current account balance. If the current account is in deficit, then the combined capital and financial accounts will be in surplus in an equivalent amount, thus achieving "balance" in the balance of payments. A surplus in these combined accounts reflects the fact that the United States is borrowing money from abroad to finance the deficit that arises because current period imports exceed exports. This borrowing entails net exports of capital and financial assets, giving foreigners increasing net future claims on the United States. Accordingly, a surplus in the combined capital and financial accounts represents net inbound investment from abroad. Combining this observation with the fact that the combined surplus in these accounts is equal to the deficit in the current account, it follows that a reduction in the current account deficit implies a reduction in net inbound foreign investment, and vice versa.

2. Balance of Payments Deficits and Section 122 of the Trade Act of 1974

If the balance of payments is always in balance, how can there be a balance of payments "deficit"? And what is a balance of payments "crisis?" To answer these questions, one must understand the role of official foreign exchange reserves and their role in exchange market intervention by governments.

A regime of "fixed exchange rates" prevailed after the creation of the International Monetary Fund (IMF) for roughly 25 years. The United States committed to maintain the value of the dollar relative to gold, and other countries committed to maintain the value of their currencies relative to the U.S. dollar. If a currency started to fall in value on exchange markets, its government would use its reserves of foreign exchange to buy its own currency and prop up the price (or convert dollars to gold at the fixed price in the case of the United States). The term "balance of payments deficit," as used by economists, arises anytime a government uses its accumulated reserves to defend the exchange rate in circumstances where the demand for foreign currency exceeds the supply, and the exchange rate would depreciate absent government intervention in that market. A balance of payments deficit is

[40] In 2024, the merchandise trade deficit was roughly $1.22 trillion, while the services trade surplus was roughly $311 billion.

not equivalent to a balance of trade deficit because capital flows in the capital and financial accounts may offset the current account deficit and prevent any exchange rate depreciation that might otherwise lead the government to intervene using its official reserves.[41]

But what if a government determines that intervention is necessary to prevent depreciation, yet it lacks enough reserves to achieve the target exchange rate? A balance of payments "crisis" refers to circumstances in which a government is running short of the official reserves needed for desired intervention.[42] One solution for a government facing a balance of payments crisis is to borrow reserves. The IMF was conceived in large measure for the purpose of serving as a lender in these situations. Another possible response is to restrict imports, thereby reducing the demand for foreign currency to buy them and leading to a relative decline in the value of foreign currency. Tariffs or quantitative restrictions can be used for that purpose.

The fixed exchange rate system of the IMF came to an end because the United States lacked adequate gold reserves to maintain the value of the dollar relative to gold, and President Nixon closed the "gold window" by announcing that the United States would no longer permit foreign governments to convert their holdings of U.S. dollars into gold at the fixed price. Fearing a rush to sell dollars on exchange markets that would produce an undesired devaluation, Nixon also imposed an import surcharge to reduce imports under authority ostensibly contained in the Trading with the Enemy Act. In the years since, the value of the U.S. dollar has generally been allowed (with occasional exceptions) to "float" freely -- that is, to be determined by market forces without U.S. government intervention.

Nixon's authority for the import surcharge was questioned both in Congress and in the courts. As part of the Trade Act of 1974, Congress responded with Section 122, designed to place clear limits on the President's power to address balance of payments problems with import restrictions. It affords the President authority to address "large and serious balance of payments deficits" or an "imminent and significant depreciation of the dollar" through a temporary import surcharge not to exceed 15%, limited in duration to 150 days unless extended by Congress.

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[41] To be sure, in a fixed exchange rate regime, persistent trade deficits were sometimes followed by a need for intervention to prevent devaluation. That issue does not arise when exchange rates are floating.

[42] As noted in the text, a balance of payments deficit arises when a government uses its official reserves of foreign currencies to support its exchange rate. As an accounting identity, the sum of the current account, capital account, and financial account balances must equal the change in reserves. Absent intervention—and thus any change in reserves—the balance of payments must, by definition, be zero. In such circumstances, balance is achieved through movements in the exchange rate. An incipient deficit induces a depreciation of the currency, which makes imports more expensive and exports cheaper for foreign buyers, thereby reducing the current account deficit. It may also make domestic assets cheaper for foreign investors, generating increased capital inflows. If the government seeks to avoid the exchange rate depreciation required to achieve balance in this manner, it must instead draw on its reserves, which must be sufficient. An extended discussion may be found in Paul R. Krugman, Maurice Obstfeld, and Marc J. Melitz, *International Economics: Theory and Policy* (11th ed. 2018), ch. 13.

After the Supreme Court held the tariffs under IEEPA to be impermissible in February 2026, President Trump quickly turned to Section 122 to impose a 10% tariff on most imports. At this writing, lawsuits are pending that challenge these Section 122 tariffs.[43] The principal argument against them is that the United States does not face a serious balance of payments deficit, and indeed cannot face such a deficit in a regime of floating exchange rates. If rates always float freely, there is no role for government intervention by definition and a balance of payments deficit cannot exist. Likewise, the United States is not facing an imminent and significant depreciation of the dollar.

We largely concur with these arguments, with the proviso that even in a system of floating exchange rates, governments still sometimes intervene in exchange markets to avert serious devaluations. When intervention is seen as necessary, a shortage of official exchange reserves can still pose difficulties. Section 122 was passed at a time when the future of the exchange rate system was unclear, and Congress anticipated that balance of payments deficits might remain an important problem. But in the ensuing half century, the United States has become comfortable operating in a world of market-determined exchange rates. We cannot be sure that intervention to address a falling dollar will never again be seen as desirable, but that scenario plainly does not apply to the United States presently.

3. Collateral Effects of "Rebalancing" Merchandise Trade

The brief review of balance of payments accounting above highlights the linkages among the various accounts. The current account balance is (for the most part) the sum of the merchandise trade balance and the services trade balance. The combined balance in the capital and financial accounts is the opposite of the current account balance, and thus net inbound foreign investment is tied to the current account balance – a current account deficit requires positive net inbound investment as noted above. Net inbound foreign investment is also equal to the difference between total investment in the United States and U.S. national savings. When investment exceeds domestic savings, the difference must be supplied by foreign investors.

The conventional view of macroeconomists is that the gap between investment and savings is a product of macroeconomic forces that will be little affected by changes in trade policy.[44] The United States has a modest national savings rate compared to many other countries, yet it is a comparatively attractive place to invest because of its dynamic and relatively stable economy. U.S. government debt is thought historically to have a low risk of default, and inflation has been moderate most of the time. These factors have led to steady net inbound investment in the past and seem unlikely to be affected dramatically by tariffs (although other concerns about the U.S. economy may affect investment going forward).

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[43] See State of Oregon et. al. v. Trump, Court of International Trade Court No. 26-01472 (filed March 5, 2026). Complaint available at https://oag.ca.gov/system/files/attachments/press-docs/Section%20122%20Complaint.pdf.

[44] N. Greg Mankiw, Principles of Economics 696 (7th ed. 2015).

Ultimately the issue is an empirical one, however, and economists are actively involved in studying the effects of tariffs on the overall balance of trade in goods and services as we discussed earlier.

To affect the current account, tariffs presumably would have to generate an appreciation of the U.S. real exchange rate. In a well-known paper, two prominent macroeconomists suggest a mechanism by which this could happen.[45] They argued that, by altering the terms of trade, tariffs effectively transfer income from exporting countries to the tariff-imposing country. Since most countries spend disproportionately on their home goods, this "transfer effect" generates an increase in demand for goods produced by the country that implements the tariff. This, in turn, generates the requisite real appreciation. However, the increased globalization of supply chains has muted the real income transfers associated with tariffs in recent years, as the increased cost of imported inputs raises the production costs of domestic goods. This observation calls into question the empirical magnitude of the transfer effect today.

We do not seek to resolve the empirical questions regarding how much tariffs will affect the various components of the balance of payments accounts. We simply offer some analytical observations about the collateral effects of "rebalancing" merchandise trade that follow inexorably from the linkages among the balance of payments accounts described above.

Our point of departure is the fact that, if tariffs lead to "rebalancing" of the merchandise trade deficit in accordance with the stated goal of the reciprocal tariffs, then either the U.S. services trade surplus must decline, net inbound investment into the United States must decline, or both. We consider each possibility in turn.

If the conventional wisdom that tariffs will have little effect on national savings or aggregate national investment is correct, it follows that rebalancing will have little effect on the current account balance. When the merchandise trade deficit declines, therefore, the services trade surplus must decline commensurately. Merchandise trade rebalancing will thus tend to go hand in hand with a shift of productive resources from the services sector to the manufacturing sector.[46]

We do not dispute the importance of certain segments of manufacturing to the overall health of the U.S. economy. Nor do we deny that favoring manufacturing over other activities may reflect a legitimate distributional choice. However, the United States exhibits strong comparative advantage in many service industries, and policies that shift resources

[45] See Maurice Obstfeld & Kenneth Rogoff, The Six Major Puzzles in International Macroeconomics: Is There a Common Cause, 15 NBER Macro Annual 339 (2001).

[46] Conceivably, tariffs could induce a decline in the consumption of goods equal to the reduction in goods imports, and an increase in consumption of services supplied by services imports, such that the current account deficit remains unchanged and domestic production of both goods and services remains the same, but this outcome seems highly unlikely.

away from those sectors are likely to entail meaningful aggregate costs. Much of the economy's recent dynamism has emerged in areas such as health care innovation, finance, artificial intelligence, and digital platform markets. Diverting resources from these high-growth activities risks undermining future economic performance.

To be sure, the Executive Order includes some claims about problems in the manufacturing sector that ostensibly require attention. One such claim is that supply chains important to economic security are threatened. Another is that problems in the manufacturing sector pose a threat to national security. Such arguments may well have some foundation for individual firms or industries (although the Executive Order does not identify them), but they do not plausibly apply to the entire manufacturing sector and are not sensibly addressed by broad, non-targeted tariffs, as we discuss further below.

Consider now the possibility that a reduction in the merchandise trade deficit will also reduce the current account deficit, contrary to the usual view of macroeconomists. If that is correct, net inbound investment will decline. How will that affect the manufacturing sector?

To answer that question, we turn to the administration's own pronouncements touting the virtues of "deals" it has struck since announcing the reciprocal tariffs, some of which contain commitments for increased foreign investment in the United States. These include a reported promise of $600 billion in new investment from the EU,[47] a $550 billion investment fund created by Japan to provide funding for investment projects selected by the administration, [48] and a $350 billion investment commitment from Korea, including $150 billion for U.S. shipbuilding.[49] The administration has also touted multi-billion-dollar investment commitments from several foreign firms, including Taiwan Semiconductor, Roche, and Novartis.[50]

Based on public reports, many if not most of these new investments will be in the manufacturing sector, indicating that new foreign investment in that sector is desirable in the view of the administration. But these new inbound investments must be financed, and the current account deficit must increase for that purpose, other things being equal. By this logic, because merchandise trade is the portion of US trade in goods and services that is in deficit today, it is highly likely that the promised new investments, assuming they materialize, will be accompanied by an increase in the merchandise trade deficit. Thus, if one takes seriously the policy goal of reducing persistent merchandise trade deficits through

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[47] See https://www.cnbc.com/2025/08/06/trump-trade-tariffs-investment-pledge.html.

[48] See https://www.wsj.com/politics/policy/trump-manufacturing-federal-land-ef3c02ba?mod=hp_lead_pos2.

[49] See Victor Cha, South Korea's Response to U.S. Demands: Minimize Risk, Maximize Reward, October 6, 2025, available at https://www.csis.org/analysis/south-koreas-response-us-demands-minimize-risk-maximize-reward.

[50] See https://www.whitehouse.gov/articles/2025/08/trump-effect-a-running-list-of-new-u-s-investment-in-president-trumps-second-term/.

"rebalancing," the administration's emphasis on attracting new foreign investment is at cross purposes.

We agree with the administration that new capital investments in the United States, financed with foreign capital, can benefit the manufacturing sector and advance the national interest. But for the reasons above, this proposition simply underscores the folly of focusing on the merchandise trade deficit as the cause of difficulties in the U.S. manufacturing sector, and the absurdity of basing country-specific tariff rates on bilateral merchandise trade imbalances.

V. Do the Reciprocal Tariffs "Deal With" Emergency Conditions in the Manufacturing Sector?

The President's Executive Order contains various general claims about exigent circumstances in the manufacturing sector involving threats to national security, unstable supply chains, inadequate defense production capacity, loss of manufacturing jobs, and other matters. But the order is devoid of detail on these claims. We are not told which firms or industries are involved, or when and why the challenges in manufacturing sector became so exigent as to require the use of emergency powers.

As noted, IEEPA not only requires an "unusual and extraordinary threat" as a predicate for the use of emergency powers but further requires that the measures taken "deal with" that threat. Thus, even if one defers to the President and accepts *arguendo* that emergency conditions of some sort exist in the manufacturing sector it is still appropriate to ask whether the tariffs, as eventually implemented, could plausibly address those conditions.[51] To this question we offer four observations.

First, the implemented tariffs applied to all merchandise imports, not just the ones that might have some relation to emergency conditions affecting individual manufacturing firms or industries. If one defers to the President on the existence of exigent difficulties in some parts of the manufacturing sector, it is nevertheless highly implausible that the entire sector is facing an emergency.

Second, and related, many of the tariffs would clearly harm U.S. manufacturing. We have already discussed how tariffs on input products used by U.S. manufacturers reduce

[51] The tariff hikes that came into effect on August 7, 2025 differed, in some ways, from the 'reciprocal tariffs' that were announced on April 2. Some countries, like Brazil and India, were hit with higher tariffs than those that were originally announced, while others, like the United Kingdom and China, faced reduced rates after bilateral negotiations. Moreover, some products were exempted from the uniform, country-specific tariffs in response to lobbying by U.S. firms or because the tariffs threatened to increase U.S. inflation. Still, the tariff regime that was enacted in August and that stayed in place until the Supreme Court ruling in February 2026 had features much like those that were originally announced, namely rates that applied broadly to most or all goods sourced from a particular origin and rates that varied by country according to its merchandise trade surplus with the United States.

their competitiveness. Such tariffs can lead to more imports of substitute goods, and a reduction of U.S. manufacturing exports. Retaliation against U.S. exports further aggravates the problem. Discriminatory tariffs can further complicate the matter as firms incur costs to restructure their supply chains and abandon sunk investments in countries that are burdened by higher tariffs.[52] Uncertainty about tariff rates can exacerbate these problems.[53]

Third, just as the President's Executive Order confuses cause and effect when it attributes manufacturing sector difficulties to the merchandise trade deficit, it neglects to consider the true causes of challenges in domestic manufacturing and how tariffs might affect them. To give one example, the Order lamented the loss of manufacturing jobs in the U.S. economy but ignored the widely documented finding that most of the decline in U.S. manufacturing jobs in recent years has been attributable to productivity growth. One prominent study in this regard goes on to find that even if foreign savings were to decline to reduce foreign investment in the United States and eliminate the trade deficit, manufacturing employment would continue to decline given productivity trends. [54]

Finally, despite minor adjustments after the initial announcement, many of the implemented tariffs (apart from the arbitrary 10% baseline tariff) were based on a calculation that yielded higher tariffs in accordance with the proportional size of the bilateral merchandise trade deficit between the United States and the country subject to the tariff. We explained earlier why this calculation rests on mistaken premises regarding a lack of bilateral trade reciprocity and a confused understanding of cause and effect. The level of the tariff on each country, and the variation in the tariff levels across countries, has no discernible connection to any emergency or to any other coherent economic objective. If such a policy does any good at all, it would be entirely by coincidence.

VI. Conclusion

In this paper, we evaluate the claims in the April 2025 Executive Order imposing "reciprocal tariffs," drawing on basic international economics. We steer clear of controversial empirical issues, focusing on theoretical points that follow from simple economic logic and factual issues that require only publicly available data. Among other things, we show that the predicate for the ostensible emergency – an exploding merchandise trade deficit – is fiction, and that merchandise trade deficits do not "cause" difficulties in the manufacturing sector as a matter of economic logic, contrary to the core claims of the administration. Further, bilateral trade deficits are not evidence of a lack of reciprocity in trading relations, and the administration's calculation of tariff rates based on such deficits is devoid of economic logic. It is unclear whether the reciprocal tariffs could materially reduce the manufacturing trade deficit as the administration asserts, and many of the tariffs

[52] See Gene M. Grossman, Elhanan Helpman & Stephen J. Redding, When Tariffs Disrupt Global Supply Chains, 114 Amer. Econ. Rev. (2024) 988.

[53] As implemented, the administration's tariffs proved volatile as various exemptions were introduced, and rates were modified in accordance with some bilateral "deals."

[54] See Kehoe, Ruhl & Steinberg, supra.

– particularly those on manufacturing inputs – will harm U.S. manufacturing interests rather than help them. To the degree that tariffs do succeed at reducing the merchandise trade imbalance, they will have adverse collateral consequences for the U.S. services sector and for inbound foreign investment. Further, because the tariffs affect all merchandise trade and are not targeted at any specific problems in the manufacturing sector, they will abate any exigent circumstances in manufacturing only by chance.