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## Tariffic Logic

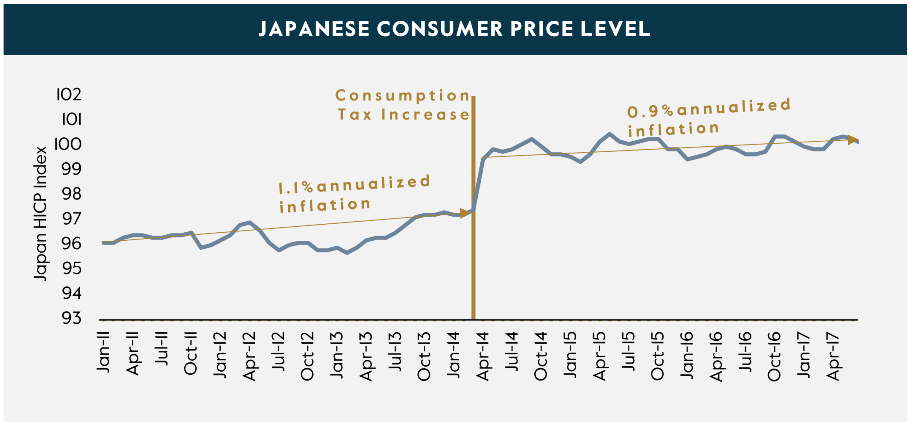
Since the owners of corporations tend to be rich, one might assume that higher corporate income tax rates increase the progressivity of the tax code. That's not necessarily the case. If corporations raise prices in response to the tax, consumers effectively bear its burden; likewise, if businesses respond by reducing wages, workers pay it.

No one disputes that the entities legally obligated to submit tax payments to the government often differ from those who ultimately bear the tax's burden. That doesn't mean it's easy to apportion the relative costs, which in the case of the corporate income tax depend on pricing power, capital mobility, wage rigidity, and many other variables. Estimates vary, but it's not unreasonable to think that less than half of the cost of the corporate income tax manifests as reduced income available to shareholders, with consumers and workers picking up the rest of the tab.

Interest in the economic incidence of taxation gained new life during the U.S. Presidential campaign. Tariffs function as a tax on imported goods. Importers are obligated to remit related payments to the government, but they may not be the ones who absorb their cost. Indeed, neither side seemed to think the importing businesses bore *any* of the burden; the debate revolved around whether the costs would be absorbed by foreign exporters or domestic end market consumers.

Even if one accepts the framing of tariffs as a "national sales tax," that doesn't mean their imposition would prove inflationary. Many economies have national value-added or consumption taxes. Increases in their rates result in a *one-time increase* in the consumer price level, which differs from *inflation*, defined as the rate at which prices continue increasing over time. This distinction is perhaps best evidenced by Japan's 3 percentage point consumption tax increase in 2014. The associated one-time price shock so badly dented consumer demand that the inflation rate *slowed* in the period following its imposition despite aggressive monetary easing (Figure 1).

**Figure 1: Tax-Related Price Shock Dents Consumption**

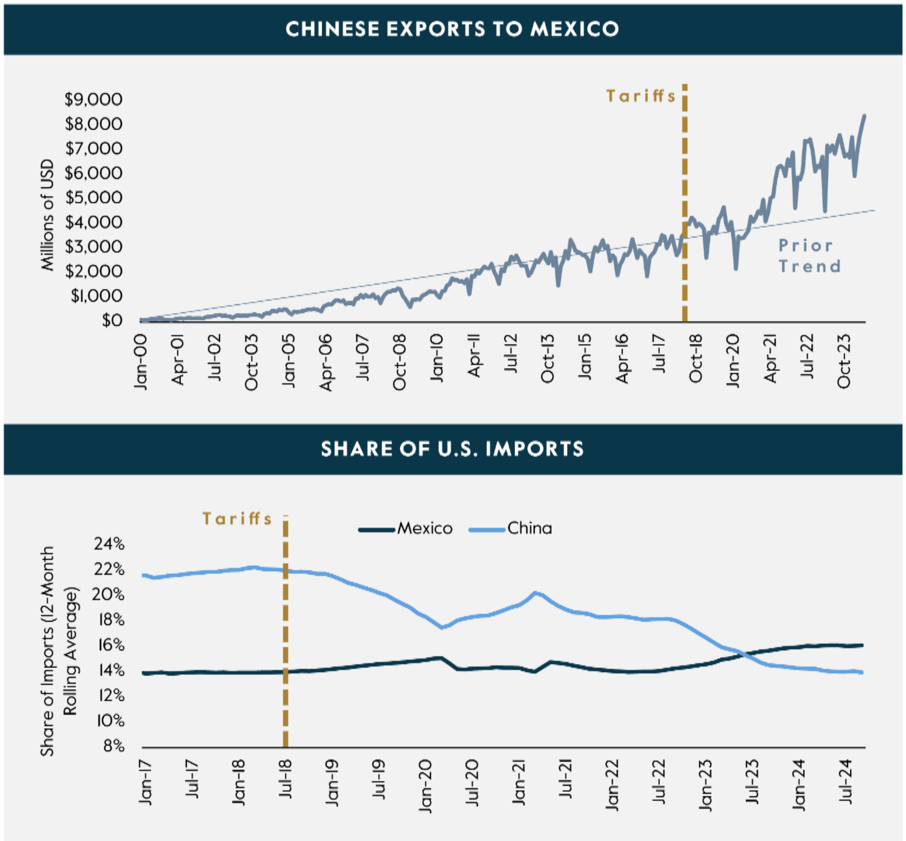



Source: Carlyle Analysis; OECD Database, November 2024. There is no guarantee any trends will continue.

Tariffs are more complicated than a consumption tax because the currencies of the buyer and seller typically differ. In a world of flexible exchange rates, one could imagine a tariff causing the currency of the importing country to appreciate relative to the currency of the exporter. There is some evidence that this happened after the U.S. imposed tariffs on China in 2018, with a stronger dollar (and weaker renminbi) bringing U.S. consumers' purchasing power of Chinese goods closer to levels that prevailed prior to the tariffs. The costs in this case would be borne by U.S. exporters whose foreign sales may be depressed by a stronger dollar.

Differentials in tariff rates across economies introduce additional complications. Higher tariffs on Chinese goods reduced Chinese exports to the U.S. but led to a curious surge in Chinese exports to Mexico. If these goods were then re-exported to the U.S., they'd be classified as U.S. imports from Mexico, a development that may have contributed to Mexico's eclipse of China as the U.S.'s top foreign goods supplier (Figure 2). More circuitous trade routes reduce revenues derived from tariffs but increase costs through added transportation expense and other frictions.

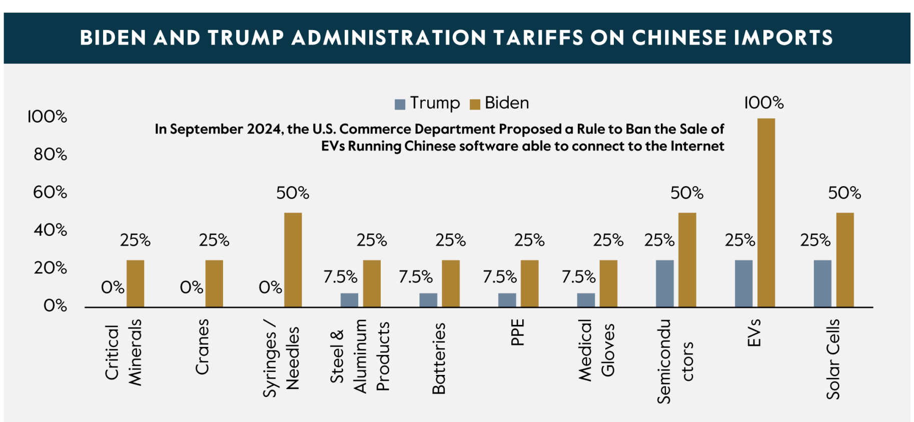
## Figure 2: Redirection of Trade Flows




Source: Carlyle Analysis; Bloomberg, U.S. Census Bureau, November 2024. There is no guarantee any trends will continue.

Finally, one must consider the cost of tariffs on goods that never arrive in the first place. Rather than rescind the tariffs on China as promised during the 2020 campaign (Compass, July 23), the Biden Administration expanded them, with a particular focus on green industries like solar modules, batteries, and electric vehicles (Figure 3). In September, the Commerce Department debuted a new rule that would ban the import of electric vehicles running Chinese software capable of connecting to the internet. (This would be like allowing the sale of iPhones as long as they don't run on Apple software.) The effect of these policies has been to deter Chinese entry to these markets. As a result, there's little-to-nothing to be taxed or tariffed, but it's hard to believe the costs to the American economy are zero.

## Figure 3: Escalation




Source: Carlyle Analysis; Tax Foundation, November 2024. There is no guarantee any trends will continue.

Economists inherit a tradition that looks skeptically on tariffs not because of their incidence, but because of their opportunity cost. A household that grows its own food, builds its own residence, and makes its own clothes is certain to enjoy lower living standards than a household that specializes in a single pursuit. Nobel Laureate Ed Prescott argued that Americans are so rich precisely because they tend to work more and use the resulting income to contract for household services, like home repairs and childcare, that households in poorer countries perform themselves.

The same logic applies to entire economies. Devoting additional human, financial, and physical capital to the manufacture of items that could be more efficiently supplied by others necessarily involves a decline in productivity. Let us hope the baseline is so strong that resulting losses don't much matter.

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