EconoFact Chats: The Impact of Tariffs on Prices
Alberto Cavallo, Harvard Business School
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Michael Klein:
Hi. I'm Michael Klein, Executive Editor of EconoFact, a non-partisan, web-based publication of The Fletcher School at Tufts University. At EconoFact, we bring key facts and incisive analysis to the national debate on economic and social policies, publishing work from leading economists across the country. You can learn more about us and see our work at www.econofact.org.

Michael Klein:
Tariffs have been a signature policy of the Trump administration. The President claims that these will protect American jobs, revitalize manufacturing in the United States, raise revenues, and importantly, not lead to higher prices. He claims that foreign exporters will bear the cost of tariffs. Is this in fact the case? Standard aggregate price statistics reflect what has happened in the past for large categories of goods, regardless of where they originated. So these statistics are not the best way to analyze the effects of tariffs on prices. A better way would be to have information on particular goods that are distinguished by their country of origin. Fortunately, these data are available through the efforts of my guest today, Professor Alberto Cavallo of the Harvard Business School. Alberto pioneered the use of online data to measure and analyze prices, co-founding the Billion Price Project in 2008 as well as PriceStats in 2011, the leading private source of inflation statistics in over 20 countries. Alberto, welcome back to EconoFact Chats. It's good to have you on the show again.

Alberto Cavallo:
Thanks, Michael. It's great to be here again.

Michael Klein:
Alberto, before we begin talking about the data, let's discuss how tariffs could affect prices. What are the channels through which an increase in tariffs leads to a rise in domestic prices?

Alberto Cavallo:
Well, you know, a tariff is like a sales tax on imported goods. But, you know, unlike a sales tax, it is not visible to consumers at checkout, so they may not fully understand how that could impact prices. But it's paid at the level of the importers. But like any tax there's someone who sends the check to the government, but then the economic incidence—who really bears the burden—depends a lot on what happens to prices. And in principle, you know, there are three parties here that could be paying the tariffs. It could be foreign exporters if they have to lower their prices. It could be importers in the US, as they bring the goods in, who bear potentially higher costs. And then it could be consumers, if those importers and US firms decide to pass this on into retail prices. So we need to look at these prices to understand who's really bearing the cost. And by the way, it's also important to understand it's not just imported goods that may see an increase in prices. It could also be domestic goods, for various reasons. They are competing with imported goods, and that competition can lead to price increases. They may have inputs that are imported as well, and that may lead also to increases in those domestic goods' prices. So

tariffs can have a variety of impacts on prices that consumers pay through all these different channels.

Michael Klein:
So given these different channels, what determines how much of the tariff is passed on to domestic prices that are ultimately paid by American consumers?

Alberto Cavallo:
Yeah. Well, first, you know, as I said, there are three parties—there's the possibility that foreign exporters will absorb the cost of the tariff by lowering their pre-tariff export prices. So you can look at that at the border, and what really determines how much they lower their prices or not is ultimately whether we, as the US, can bring these goods from other locations. If we have alternative suppliers that can provide these goods to us, then we can push more of the burden on these foreign exporters. That's one important dimension. And we, by the way, saw that in the first trade war. The US was bringing goods from China that were differentiated, that we couldn't bring from other locations in the short run. So most of the burden was on the US importers at the time. By the way, if you looked at exports of the US at the time when China retaliated on US exports, the Chinese could bring those goods that it was bringing from the US—mostly agricultural products—from other locations, so the US exporters had to lower the price. So that is an important thing to remember. The kinds of goods that we are putting tariffs on, and how many alternative suppliers there are on a global scale, definitely determines part of the cost that a country bears for imposing tariffs. And then at the consumer level, it's even more complex. There are many mechanisms. Obviously, the size of the tariff matters, the scope of the tariff—how many goods are getting affected. If you think of domestic goods in particular, how important are those imported inputs in their total costs, how closely they compete with imported goods that may be increasing their prices? So all those are related to the actual mechanical, if you will, increase in the cost structure of these goods. But there are also decisions that retailers have to make. They can decide to absorb and eat some of that cost in the short run, if they, for example, expect the tariffs will be temporary. They have to decide on that. If they are uncertain about the levels of tariffs…where they will end up, they may also decide to delay some of this pass-through. They also have lots of adjustment mechanisms as well. They can front-load inventories, try to bring goods from different locations to avoid the tariffs. They can ask for exemptions. All these things are quite important, and they determine how quickly we end up seeing some of that effect being passed on to consumers.

Michael Klein:
I guess one issue now is that there aren't just tariffs on China. There are tariffs that very widely across the world, so there are going to be fewer competitors we could turn to where the prices don't rise. Is that correct?

Alberto Cavallo:
That's correct. The broader you make these, the less chance you have of what economists call trade diversion—bringing goods from other locations. Although it's also important to remember that what ultimately matters for these decisions of where you bring the goods from is the relative tariff rates. So if we impose a much higher rate on China than on other locations, the one that would be binding, if you will, is the lowest one if we can get supplies from those locations. So

this will again increase the complexity. And I think one of the biggest issues right now is that there's just a tremendous amount of uncertainty about the ultimate levels…on who will get a tariff or not. So many of these decisions are actually just being delayed at the moment. And it's part of the reason, I think, why we're not seeing much impact yet on retail prices in particular.

Michael Klein:
Well, let's move to empirical analysis from theory. Your data are particularly well suited to address the question of how tariffs affect prices. To start off, can you describe your PriceStats project, and how many prices do you collect, how frequently, and from how many sellers?

Alberto Cavallo:
Yeah, so PriceStats is a private company that has been collecting data from large retailers since 2011. And there are dozens of large retailers in the US and in other countries. The data is collected every single day for all the goods that these retailers sell through their websites. They're mostly what we call multi-channel retailers that have a big presence offline and online. And that data is used to measure inflation, but it can also be used in cases like this, where we find individual goods, we can understand where they come from, and we can look at the impact that the tariffs are having on these specific goods. So in the research paper that I'm working on right now, what we do is we take the micro data with the products, the prices, and then we find out what is the country of origin of each individual good. To run this analysis, we use a variety of methods, including using AI to search for the product online and try to identify the ultimate source of these products.

Michael Klein:
Well, that's a really impressive undertaking, Alberto, and I know that people have been very impressed by what you've done, you and your team have done with this and made it available to businesses but also for economic research. So that's the price data. What about tariffs? Just to review, when were they put in place, how much did they differ across countries, and were they kept on, or lowered, or removed or raised?

Alberto Cavallo:
Yeah, so that's a great question. The first tariffs that the administration imposed were about 10% on China in February. And then in March, Canada and Mexico got 25%. China got another 10%. And then later in April, we saw what was called the Liberation Day announcements—much broader tariffs being applied, with a minimum of 10% for most countries. And then we saw an escalation of tariffs with China for a while. They got to above 100%, then they came back down. So we've seen a lot of volatility now. Right now, countries like China are facing 30% in addition, by the way, to all the tariffs that had been imposed in the first trade war. And you get a few countries like Brazil and India getting 50% rates that have just been implemented last month. Most countries are getting about 10%, although the deadlines keep on being pushed, and there's uncertainty not just about the levels that they'll end up with, but rather about whether a deal will be signed, and even, for example, lately, on whether the tariffs will be legal or not. There's some challenges in the courts right now. So there's tremendous volatility in these levels, and there's a lot of uncertainty for both importers and retailers who have to decide on prices of goods at this time.

Michael Klein:
Canada and Mexico are among the biggest trade partners of the United States, and one complication is that the tariffs imposed on these two countries may be counter to the US-Mexico-Canada Free Trade Agreement that was signed during President Trump's first term. Did this exempt some of the goods from the national level tariffs?

Alberto Cavallo:
Yes, it did. In fact the initial announcements were quite broad, and then the government had to clarify that a lot of the goods that were part of the previously signed USMCA agreement had to be exempted. Some economists have measured the effective tariff rates by looking at imports that have happened in the last few months and trying to estimate how much the actual tariff applied to some of Mexican goods, for example, have been, and numbers are quite low because of these exceptions that you're describing. And I should also point out that it's also consistent with what we see at the retail level. We find relatively little pass-through, particularly for Mexico—not so much for Canada, we see a little bit more there. But that is important to know, and, you know, this level of exemptions is sometimes not known until several months afterwards, because some particular firms or categories of goods get exempted, and the information is not immediately available to researchers.

Michael Klein:
So this you know incredible variability in tariffs is probably really bad for businesses, but maybe it's good for economists, because when we do empirical analysis, we want to see a lot of variability so we can tease out the effects of things. In your analysis, Alberto, what did you find out about the effects of tariffs on the prices of imported goods? And I imagine that the answer is different for different goods from different countries, right?

Alberto Cavallo:
Yes, that's correct. So, the first thing we did is we separated goods between imported and domestic, and we found that the news and announcements that were made about the tariffs did have a quick impact. There were some quick reactions in the price data. For example, when the first tariffs in March were implemented, we saw a jump of about 2% in imported goods prices. And then as news of deals or escalation of the tariffs happened, we did see reactions in the data. But one thing that stands out is that the overall pass-through into consumer prices has been very gradual. It's not like it happens for the full amount of the tariff immediately…a one-time…but rather the way retailers are reacting is in a very gradual process. And the magnitude, by the way, is also not large yet relative to the size of the tariffs. So we find roughly that imported goods have increased since March until right now by about 4%, which compared to the size of the announced tariffs, particularly for China, 30%—is not that large. You can adjust this and compare it relative to the pre-tariff trends, but you get slightly higher numbers of about 5%, which is not that significant. So the big takeaway is that we see this gradual pass-through that is consistent with this idea that there's a tremendous amount of uncertainty and it's a complex pricing decision for firms. We also find, as you start looking at the details, big differences between countries. We found that most of the price increases today are concentrated on Chinese goods, which is precisely where we've seen higher tariffs…more of an escalation of the trade war lately, and we don't find much, like I said before, in the case of Mexico, where not only they're getting exemptions, but I think there's this feeling that there might be a deal that can be

reached between the US and Mexico. That is less likely, potentially, with China, where the tensions are greater. So there's a tremendous amount of heterogeneity, as we say—differences across sectors—that is worthwhile exploring.

Michael Klein:
And part of this is, I would think, that it really hasn't been that long, right? Since April, that these have been put in place. And there are reports that firms, rather than raising prices, were cutting back on their inventories and not raising prices. So do you think that the results that you found to date are going to be similar to the results that you will find as you continue this over the next, say, year?

Alberto Cavallo:
Yeah, well, we did a similar analysis back in the first trade war. And we looked at the retail pass-through about a year and a half after the tariffs had been put in place, and we found evidence of also a very gradual pass-through. And like I mentioned, I think you're alluding, for example, to the fact that there's a front-loading of inventories, that these firms have brought a lot of goods before the tariffs were put in place, and that helps delay the pass-through. But there are many of these other mechanisms as well, that I described, that should make this a very slow-moving impact on inflation. So I think that's to be expected, and I would expect it to continue. One thing that is special of this current situation is just that there's so much uncertainty. We don't really know what will happen. And perhaps if that uncertainty gets dissipated, and the government settles on a particular tariff rate, and there are no doubts that the level is going to remain there, we might see an acceleration of the pass-through. But I don't think we're there yet. And there are so many challenges now in the courts that I feel that uncertainty level will remain, and it will continue to make this process very gradual. Which is interesting, by the way, from the consumer's perspective. Because if we look down the road maybe two or a year from now, if we were to compare prices to today, we would see a significant difference. But if the pass-through is very slow, consumers may not even notice it, and that means they won't also link it to the tariffs, or blame the tariffs for that. And it might make the tariffs actually popular among many, many voters in the US. So all this is actually quite important also from the perspective of what consumers will perceive and how they will react to the tariffs.

Michael Klein:
You know, Alberto, in some ways, this question is similar to one of how does a change in the exchange rate pass through to domestic prices? I remember that there's a lot of analysis of this in the late 1980s and early 1990s when the dollar went through very big swings. One of the findings of that analysis was that there was the perceived permanence of the change in exchange rates mattering a lot for the pass-through to prices. And as you're indicating with tariffs, there's also this issue of permanence. As a president backs down from some of the tariffs and reimposes more, then backs down from those. So it seems like you're suggesting that, just like the exchange rate in the 80s and 90s, where people weren't sure whether the swings would be permanent or not, this uncertainty is also an important factor these days. Would you agree with that?

Alberto Cavallo:
So I agree. And to be clear, the permanence of the tariffs matters because it's costly for firms to change prices all the time. Now one of the costs, by the way, that firms talk a lot about these days

is their fear of antagonizing customers. So you don't want to raise prices if you're going to have to lower them down the road. And that cost means that you want to be certain that the tariffs are going to be there, and you won't have to change again a few months from now. So when you get that uncertainty about the future, firms are forward-looking. They have to make pricing decisions today, and they may adopt a wait-and-see attitude. And that happens with pricing, with investment decisions, with lots of decisions. And that's certainly, I think, playing a role for many of these firms today. One interesting effect that we did find in our data, connected to specifically this fear of antagonizing customers, is that for some of these retailers, the visibility of the tariffs impacting a particular good is actually quite important. If consumers know that a particular good is getting affected, then it's easier for the retailer to pass it on, and that leads to differences. For example, in the first trade war, there was a big increase in washing machine prices right after the tariffs were imposed. But that was a very visible tariff that got discussed a lot in the news. When you get tariffs affecting a large number of goods, and it's not clear which country is getting affected more, or even where the good comes from, all that leads to a lot of uncertainty, and it makes it harder for the retailers also to explain to their customers why the cost of these goods has gone up, and why they need to raise prices for these goods.

Michael Klein:
The research on washing machine prices during the first trade war also showed that dryer prices were going up, right? A complementary good. And that leads me to my next question. Goods that are produced domestically and don't have any foreign content, but are competing with imports…say the producers of those goods, or the sellers of those goods, can raise their prices as well, right? And one issue with that for tariffs is that when those prices are raised, there are no revenues that are received by the government—unlike, say, if there was a sales tax on all goods. So did you find that domestically produced goods that compete with imports, those prices rose as well?

Alberto Cavallo:
Yes, we did. So if imported goods' prices rose by 5%, domestic goods' prices rose by about 2.5%. And if you look specifically at domestic goods that are competing intensively with imported goods, the magnitude rises and becomes quite similar to those of imported goods. And it sort of makes sense, you know—even if they don't have imported inputs and their costs have not risen, they are in competition with goods that are brought from abroad and have higher costs now…they have to raise their prices, and that actually gives them more pricing power. The domestic goods can increase as well, and we've seen that happening in the first trade war, and it's also happening today, particularly, as I said, on goods that are directly competing with those imported goods. And it sort of highlights how broad the impact could potentially be of a tariff. It's not just affecting imported goods, but also those that are produced domestically and competing with them.

Michael Klein:
Also, Alberto, put this in a bit of context. You said that the pass-through isn't so big. So if you have, like, a 20% tariff, it could be a 4% increase in prices. But 4% inflation is well above the target of the Federal Reserve, which is 2%. So even if the pass-through isn't big, that increase in prices is large relative to what policymakers want inflation to be. Correct?

Alberto Cavallo:
Yes, that's correct, although one thing we haven't mentioned is that the impact that we are detecting is particularly in sectors like household goods, furniture, electronics, which don't have such a big weight on the CPI basket. So when we're talking about inflation on an aggregate basis, which is what the Federal Reserve would target, the impact wouldn't be that great. Because, by the way, we're not seeing such a big increase overall. But still, like you said, 4% or 5% would be big if it affected the whole basket. But it's mostly affecting at this stage sectors like household goods and electronics, which have a relatively small weight of about 10% overall in the CPI basket. If the tariff were to be expanded and start affecting also food, that would start having a bigger impact on the aggregate numbers. The other thing that might be important also to remember is that the tariffs are thought of as a supply or cost shock, affecting the costs of many goods. But the announcements of the tariffs also have potential demand-side effects as well. So when we had the April 2 announcements that President Trump made, there were a lot of concerns about how the US economy would react–whether we would go into a recession. There were certainly fears of a global recession, and then the price of oil came down in global markets, which eventually leads to lower energy prices. Fuel prices have a big weight on the CPI basket, and those effects actually compensated for some of the increases we are starting to see on these categories affected directly by the tariffs. So it's important to remember, when we think about aggregate inflation, that there are all these different sectors that could be differently affected by the tariffs over time.

Michael Klein:
So finally, Alberto, I'd like to talk about the revenues from tariffs. And this, again, as I mentioned in the introduction, is something that has been touted as an important role for tariffs. What does your analysis of price changes say about who bears the cost of the tariffs and who's paying for these government revenues?

Alberto Cavallo:
Right. So to really understand who pays for the tariffs, you need to observe prices at the border to know if foreign exporters are lowering their prices or if importers are paying. And then you have to look at them at the retail level. We don't have right now in our research, data at the border, like we did in the first trade war. But if you look at import price indices, which are produced by the BLS, and those are price indices before tariffs, you do get a sense that those import prices have not fallen pre-tariffs. So the foreign exporters are not lowering yet their prices at all. What that means is that the importers in the US, as a whole, are paying for those revenues that the government is increasing. And then once you think of the US—is it importers or consumers? The fact that there hasn't been too much pass-through at the retail level suggests that it's mostly the US firms who are bearing that cost and paying for those revenues that the government is increasing and obtaining. So I think that's where most of the burden lies today—with US importers and US firms that are deciding to eat some of these tariffs. Not with foreign exporters like the President would have hoped, and not also yet much with consumers.

Michael Klein:
But do you think, again, you know, asking you to project a little bit, looking forward, do you think then eventually, if the prices are passed on to the consumers, it becomes a tax on

consumption? Which we know is a very regressive tax compared to something like the income tax or an estate tax.

Alberto Cavallo:
Absolutely. I mean, the more time passes, like I said, this gradual process—even though the magnitudes are small—it accumulates over time, and consumers end up paying a big part of that tariff increase. Like you said, this is a kind of tax that also affects where some things are produced or sourced from, and usually not from the most efficient producers. And that leads to distortions that affect us as well. And we are only just speaking about the price impact as well. But there are lots of other decisions that are affected by these that could lead to worse outcomes. For example, imagine retailers decide not to raise prices. They may decide not to bring goods from abroad because they may think that they cannot raise their prices and the consumers won't accept them. They may decide just not to import and offer those goods for sale anymore. So we may see a decline down the road of the variety of goods that are available for us to purchase at the stores. And that's an impact on our welfare. Having less choice is bad for us. So those are also similar dimensions that we need to keep an eye on moving forward.

Michael Klein:
Alberto, I again commend you on this amazing project that you've undertaken, which really provides important information that otherwise, really, I think would not be available to researchers or businesses. So congratulations on that, and thank you for joining me once again on EconoFact Chats. I always enjoy my conversations with you.

Alberto Cavallo:
Thank you, Michael. And let me just add—we have a website where we update our results periodically. So if anyone is interested, they can go to pricinglab.org. They're going to find a tariff tracker, and they can see results in sort of real time. So I hope this is useful. And it's always a pleasure to be in EconoFact. Thank you for having me.

Michael Klein:
And thank you again Alberto.

Michael Klein:
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