Tariff Wars: Opportunities and Threats for Firms

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Abstract

Import tariffs play a major role in trade wars. In this paper, we analyze how import tariffs will affect competing firms' profits and their strategic decisions about where to locate their production and how to price their products in each market. While import tariffs make a monopoly firm worse off, our analysis of a competitive market reveals that each firm's profit loss in its foreign market due to import tariffs can be dominated by its profit gain in its domestic market, i.e., having import tariffs can be a win-win for both domestic and foreign firms. Further, having higher import tariffs can lead to a higher profit for each firm. However, a prisoner's dilemma situation may prevent the firms from receiving the benefits from the tariffs. The reason is that, to avoid paying the import tariff, each firm may choose to start production in the foreign market, which will lead to more intense price competition and lower profit for all firms. Our analysis shows that the real threat for the firms from import tariffs is not the increased marginal cost when the firms export their products, but the firms' incentives to evade the tariffs by starting production in the foreign markets.

Keywords: *tariffs; pricing; production location*

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