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The U.S.-China Trade War and the Tariff Weapon

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Abstract

Managing the U.S.-China Trade War ranks among the most difficult foreign policy challenges for the Biden administration. It should not be weighed down by misguided Trump-era thinking on the strategic virtues of tariffs. The Trump administration cast tariffs as a panacea for all the economic challenges facing the United States and employed them to achieve contradictory strategic ends. Tariffs have distributional consequences, and their efficacy must be evaluated by the net effect on the whole U.S. economy. Research suggests that section 301 tariffs have caused great collateral damage to U.S. businesses and consumers without generating the leverage over China or reducing trade deficits as advocates hoped. This is because large companies are not responding to tariffs by abandoning China but by passing on the costs or circumventing tariffs. Tariffs have instead become a regressive "hidden sales tax" that places a disproportionate burden on the less affluent by contributing to rising consumer prices and on small and medium enterprises that struggle to remain competitive. Tariffs have trapped the United States and China in a massive economic war of attrition that grows costlier by the day without yielding measurable strategic benefits.

Implications and Key Takeaways

- Despite the economic toll on both economies, tariffs have achieved few of the strategic ends articulated by the Trump administration. The United States should scale back section 301 tariffs in favor of policy instruments that cause less collateral damage on the American economy or are more effective at achieving desired strategic ends.

- Rolling back tariffs does not mean capitulating to China but a change in U.S. tactics. U.S. efforts to increase investment in science and technology, to strengthen foreign investment screening, and to add companies with links to the Chinese military to the entities list, all serve strategic competition much more so than tariffs.

- The United States should seize the opportunity afforded by growing inflation concerns to reframe the characterization of tariffs as not "tough

on China" but bad for the American economy. It could also pair tariff reductions with Chinese cooperation on the Russia-Ukraine War.

- The United States could also do more to address structural imbalances by strengthening export competitiveness. This involves traditional measures such as maintaining a competitive exchange rate and negotiating trade agreements but could involve new policies such as taxing capital inflows and use the revenue to subsidize exports.

- The failure of section 301 tariffs is a cautionary tale against an all-or-nothing approach to strategic competition with China. The Trump administration hoped tariffs would achieve an expansive and contradictory set of strategic goals and overplayed its hand. Tariffs can be a source of leverage, but they are best threatened and not used. The costly tariff stalemate could have been avoided had it made a more focused set of asks.

I. Introduction

Tariffs are inflicting real economic costs on the United States while their purported strategic benefits remain illusory. In 2018, the Trump administration imposed section 301 tariffs on China to combat the forced transfer of technology from American firms, to stop cyber-intrusions to access U.S. business information, and to curb Chinese industrial policies such as the Made in China 2025 initiative. Members of the administration also vocally advocated the strategic virtues of tariffs in reducing economic reliance on a geopolitical rival. They claimed the long-term, strategic gains from encouraging companies to bring jobs back to this country by raising import costs[1], and reducing the trade deficit[2] justify the short-term pain of tariffs. Some even saw tariffs on China as a "poor man's TPP," by making China a less attractive destination for foreign investors relative to U.S. allies.

The Biden administration's approach to managing the U.S.-China Trade War has been rightfully criticized as "Trump lite".[3] Average U.S. tariff levels on Chinese goods have increased over six-fold since 2018 and cover two thirds of imports. Researchers have noted that this "trade war stands out as among the largest and most abrupt change in U.S. trade policy history, particularly when juxtaposed against the leading role historically played by the U.S. in driving tariff reductions."[4] Most of these new tariffs remain in place today, over two years after the signing of Phase One deal on January 15, despite mounting evidence that the trade war has hurt the U.S. economy without achieving its original aims.

This essay will focus on tariffs. Even though the U.S.-China Trade War has metastasized into a "tech-war"[5] and may be escalating towards a "New Cold War,"[6] tariffs are where the short- and medium-term costs of the trade war are the most evident. Tariffs are political crowd-pleasers because they give the executive the appearance of decisive action and allows for selective redistribution of revenues to cronies, but they are quite counterproductive in actuality by imposing higher costs on society as a whole.[7] They are a blunt instrument that have elevated uncertainty and raised costs for businesses but have not caused large and consequential MNCs to exit China.[8] Instead, they serve as a regressive tax as higher costs are passed down the supply chain to the businesses and consumers who can least afford to pay them.[9]

Both the United States and China are losers from the trade war, with the costs falling disproportionately on those who can least afford them. While well intentioned and impressive sounding, claims about the strategic virtues of tariffs for the United States are contradicted by the weight of evidence. The Trump administration tried to use of tariffs to achieve contradictory goals, the resulting strategic muddle was further exacerbated by how businesses have responded to tariffs in unanticipated ways.

The Biden administration has advocated a trade policy that supports the middle class through stable well-paying jobs in order to further help the United States "build back better" from the COVID-19 pandemic. Tariffs at best do not contribute to these goals and at worst undermine this vision. Section 301 tariffs have not resulted in measurable reshoring of industry or a reduction of the trade deficit but they have exacerbated supply chain disruptions and inflated consumer prices. Tariffs, and the byzantine process for tariff relief or exemption, chiefly benefit the politically connected and deep pocketed, while the rest of the country bare their costs.

II. The Road to Decoupling: An Intellectual Framework

The rise of China, a geopolitical competitor that is also a leading U.S. trade partner, has challenged the conventional wisdom that views economic interdependence as a force for good in and of itself. But it was not until the outbreak of the trade war in 2018 that economic decoupling between the U.S. and China went from unthinkable to inevitable. This push for economic decoupling marks a stark reversal of the half-century consensus among U.S. policymakers that freer trade will encourage China's peaceful integration into the liberal international order.

2.1 The Emergence of Economic Nationalism

The outbreak of the U.S.-China Trade War can be traced to efforts by both countries to reduce perceived vulnerabilities that stem from asymmetric economic interdependence. Scholars have long recognized that economic interdependence creates both mutual benefit and mutual vulnerability, and that coercive power can emerge from asymmetrical interdependence.[10] China's accession to the World Trade Organization (WTO) in 2001 created political

backlash in both China and the United States, where fear about economic dependency stoked the embers of economic nationalism in both countries.

In China this political backlash took place earlier and caused the government to embrace indigenous innovation (自主创新) to reduce asymmetrical dependence on foreign technology in the mid-2000s.[11] In the United States, it gained momentum after the Global Financial Crisis as the growing trade deficit with China and its growing purchase of U.S. debt became framed increasingly as a national security issue rather than an economic one. Both trends were driven by the domestic political and economic transformations that followed China's WTO accession, which created winners and losers through increased international competition. The economic losers from growing interdependence were able to succeed politically by shifting national discourse from a liberal narrative that emphasized the mutual benefits of interdependence to a nationalist one that fretted about mutual vulnerability.

These parallel trends in China and the United States would converge with the election of Donald Trump and touch off a series of events that transformed trade from a cornerstone of peace in the U.S.-China relationship to a source of uncertainty and instability. Trump's China-bashing campaign brought the issue of asymmetric interdependence with China into mainstream American politics. In 2016, 63 percent of Americans surveyed by the Chicago Council favoured friendly cooperation and engagement with China but by 2020, this percentage dropped to 47 percent.[12] The percentage who believed that China practiced unfair trade increased from 58 percent in 2006 (prior to the Global Financial Crisis) to 68 percent in 2017 (after the election of Trump) and to 73 percent in 2020 (after the trade war).

2.2 Misplaced Anxiety Over Asymmetric Interdependence

The United States and China remain highly interdependent across multiple economic dimensions but the relationship is imbalanced in several notable areas. The tragedy of the trade war stems from nationalists in both countries choosing to focus on different dimensions of the relationship that are unquestionably asymmetric rather than examining it as a whole. Beijing and Washington are racing to wall-off access to their domestic market and reduce dependency on foreign suppliers to address perceived national security vulnerabilities. These efforts to mitigate perceived asymmetries and enhance security

in one area, such as Chinese efforts to reduce reliance on U.S. technology or U.S. efforts to screen Chinese investments, threaten overall interdependence and contribute to an economic security dilemma.

In 2020, trade between the two totaled $615.2 billion, which contributed to a $310.3 billion trade deficit for the United States. The financial relationship is even larger, totaling a staggering $5 trillion. China holds $1.07 trillion in U.S. debt, which makes it the second largest foreign debtor at 15.5 percent, behind only Japan at 18 percent. Another $2 trillion are Chinese listings in U.S. stock exchanges. Foreign direct investment (FDI) from China accounted for a much smaller share of U.S. FDI inflows, at $38 billion, far behind Japan who is the largest foreign investor in the U.S. at $647.7 billion. The United States is one of the largest sources for FDI in China, investing over $123.9 billion in 2020. The United States and China are also linked by a robust education and talent pipeline: China is by far the largest source of international students to the United States at 380,000 (the next highest is India at 190,000). There are over 2.5 million Chinese immigrants living and working in the United States, around 10,000 American students in China and as many as 100,000 American expatriates that live and work in China.

The ability to "weaponize" asymmetrical interdependence to gain political leverage is not as straightforward as it would initially appear. For example, the United States runs a large trade deficit with China but this paradoxically gives asymmetric leverage to the United States because China depends more on U.S. markets than we rely on theirs. American tariffs on China were supposed to work because China needs to sell more to the United States than the United States needs China. In other words, they wouldn't work if the United States didn't run a trade deficit with China.

Furthermore, the trade deficit is what contributes to an investment surplus that reduces the cost of sovereign borrowing for the United States and makes China one of the largest holders of U.S. debt. While China's accumulation of U.S. debt has also sparked anxiety about asymmetric interdependence in the United States, the scholarly consensus is that this leverage is more theoretical than practical.[13] As one senior Chinese official put it, "U.S. Treasuries are the safe haven. For everyone, including China, it is the only option...we know the dollar is going to depreciate, so we hate you guys but there is nothing much we can do."[14] So, China may enjoy asymmetrical advantage in debt, but it is

because it is the largest holder of U.S. foreign exchange (dollars used to pay for Chinese goods). This, in turn, gives the United States the asymmetrical power to put more tariffs on China than China can retaliate back with. So does asymmetric interdependence actually favor the U.S. or China in aggregate? Both and neither.

The economic security dilemma is also playing out in the area of foreign direct investment. The Chinese government has long been concerned about the asymmetry created by foreign companies gaining market share in China and reliance on foreign technology. Beijing has erected barriers for foreign businesses while adopting policies to encourage Chinese firms to invest abroad. These industrial policies are at the heart of Washington's justification for the trade war. They, in turn, brought Chinese style obsession over national security to the U.S. foreign investment screening process, resulting in the Foreign Investment Risk Review Modernization Act of 2018 (FIRRMA). China responded by updating its own rules for national security review of foreign investment (外商投资安全审查办法) in 2020.

2.3 Sleepwalking towards Decoupling

Economic linkages between the United States and China are often asymmetrical when viewed individually, but it is not at all clear how such asymmetry translates into coercive leverage overall. What is clear is that the wave of economic nationalism unleashed by the trade war and Donald Trump's "America First" foreign policy threatens all economic ties with China, not just those that create asymmetric vulnerabilities. This tragic slide towards decoupling was not inevitable, but rather the product of a series of miscalculations by different actors in the United States and China.

What becomes clear in retrospect is that different actors in the leadup to the trade war all came to see tariffs as the means to achieve wildly different ends. Donald Trump believed that tariffs could reduce the trade deficit and bring back the jobs he promised to his supporters. Protectionists supported tariffs because it shielded their industries from Chinese competition while punishing China for its unfair trade practices. Multinational businesses, which benefited from trade with China did not share these goals, but they saw tariffs as a convenient way to pressure Beijing to level the playing field in their favor. While protectionists did not much care about how China might

respond, Trump and the multinational advocates of tariffs expected China to capitulate rather than jeopardize its profitable economic relationship with the United States. But the result was a maximalist set of demands that exceeded the economic pain of tariffs and Chinese leaders, overconfident in their ability to outmaneuver Trump, saw retaliatory tariffs as preferable to acquiescence. This mutual confidence led to bargaining failure and resulted in the largest trade war in history, an economic war of attrition that continues to grind on today.

The following sections will review the strategic logic of U.S. tariffs as well as China's retaliatory tariffs. This will be followed by an analysis of the short- and medium-term impact of these tariffs on the United States and Chinese economies to determine whether they achieved the intended strategic objectives.

III. Strategic Logic of U.S. Tariffs

The logic of section 301 tariffs suffers from muddled strategic thinking. Their adoption by the Trump administration seemed to reflect the need to do something to address long-standing trade tensions with China despite unresolved disagreements about the desired ends tariffs were supposed to bring about. Tariffs raise costs for imported goods, thus their effects depend on which economic actors end up shouldering these costs and whether they change their future behavior in response.

If the net effect of these changes is beneficial to the United States, then they can be considered strategic. However, a systematic review of their anticipated effects reveal that they are far from the miracle silver bullet for strategic competition with China that many policy-makers believe they are. The Trump administration have, at different times, characterized tariffs as achieving strategic ends that sometimes contradict each other:

Punishment: Tariffs that function as payback against Chinese "economic aggression" and undercut Chinese competitiveness. This logic was particularly prominent in the initial two of four lists of U.S. tariffs, which targeted $50 billion worth of products from industrial sectors that contribute to or benefit from Made in China 2025.[15] This logic assumes zero-sum competi-

tion with China. For this logic to be true, the costs of U.S. tariffs are taxes on Chinese exports paid by U.S. importers. If all exporters in China were Chinese, the distributional impact of tariffs would be straightforward. They should raise costs for all China-based producers creating goods for sale in the U.S. market, making them relatively less competitive than U.S.-based producers. But in a world of global value chains and MNCs, things get complicated. In 2018 alone, over 40 percent of Chinese exports was conducted by foreign companies. This means that a sizable number of U.S. and allied companies are also hurt by tariffs. Additionally, U.S. firms that import Chinese components also face higher costs, potentially becoming less competitive relative to European and Asian competitors that can import Chinese components more cheaply. It is not clear whether tariffs are really undercutting Chinese or American competitiveness.

Leverage: Tariffs would push more companies to divest from China and reshore supply chains to the United States unless China makes difficult reforms. This logic assumes cooperation with China is possible and that imposing some costs on China will make it more willing to negotiate. The central assumption of the leverage strategy is that tariffs will induce some MNCs important to the Chinese economy to leave the country. But this assumes that MNCs will leave China rather than simply pay the cost of tariffs. This does not appear to be the case, especially for larger MNCs, which have the market power to pass the cost of tariffs on to customers and a variety of means to avoid duties by exploiting loopholes in trade law. As a result, small and medium enterprises are the most sensitive to tariffs and their pain doesn't generate the kind of leverage that would get China to engage in structural reforms.

Additionally, there's some tension between using tariffs for punishment or for leverage, since the former requires narrow targeting to avoid non-Chinese companies while the latter requires imposing significant costs on foreign MNCs. If punishment featured more prominently in the targeting of List 1 and 2 tariffs, the logic of leverage was more central to List 3 and 4 tariffs. These later tariffs covered a much broader number of product lines and were intended to increase pressure after China imposed retaliatory tariffs rather than capitulating. This difference in intent is why thousands of U.S. companies have sued the Trump administration for List 3 and List 4A tariffs because

of the expansion of tariffs for reasons untethered to the unfair Chinese practices it originally investigated and why the WTO has found the U.S. in breach of trading rules.[16]

Protectionism: Tariffs shield domestic producers from foreign competition and offer selective compensation of political supporters. This logic is driven by domestic political considerations and has special resonance with Congress because it promises job creation. Politicians have historically imposed tariffs as a means of curating political favor with local interest groups interested in "buying" protection through campaign contributions. The Trump administration liked to tout the new revenues generated by tariffs and the jobs created in the steel industry. Nevertheless, it spent more on compensating farmers who suffered from Chinese retaliatory tariffs,[17] and U.S. manufacturers as a whole shed more jobs than gained them because of rising input costs.[18]

This gap highlights the central problem with the siren song of protectionism: it creates a deadweight loss on the economy as a whole while benefiting politically connected interest groups. This is why political economists have long believed that the executive branch would oppose tariffs because it has to consider the welfare of the nation as a whole while the legislative branch would be inclined towards enacting more to satisfy their local constituents. Additionally, the logic of protectionism likely undercuts punishment as well as leverage because the targeting of tariffs could not be strategic if driven by parochial domestic interests.

Structural deficit: Tariffs are a means to reduce the trade deficit with China and reverse U.S. dependency on foreign debt. This logic seems to be favored by former President Trump and USTR Lighthizer who see the trade deficit as the U.S. trading future wealth (through borrowing) for short-term consumption.[19] According to an account of trade negotiations, the Trump administration refused a Chinese offer in March 2018 to head off the trade war by reducing trade barriers and demanded instead that Beijing quickly cut its $375 billion trade surplus with the United States by $100 billion.[20]

While it is true that the trade deficit leads to a financial account surplus, which reduces the cost of U.S. foreign borrowing, it is unclear whether tariffs will help reverse these structural imbalances. U.S. tariffs on China may

reduce imports but they have also prompted retaliatory tariffs and raised the cost of U.S. firms producing goods for export. Both will reduce U.S. exports. Tariffs have also prompted some trade diversion to countries like Vietnam, expanding the U.S. trade deficit with those countries. This means that tariffs on China is unlikely to change the overall trade deficit. This is exactly what we see empirically, the U.S. trade deficit grew to record levels in 2020 and will reach new heights in 2021 despite high tariffs. The bilateral trade deficit with China did shrink in 2019 but so did pressure to reduce the growing trade deficit with Vietnam. A better way to address structural imbalances would be to tax capital inflows and use the revenue to subsidize exports.

IV. Strategic Logic of Chinese Tariffs

In contrast to the muddled strategic logic of U.S. tariffs, Chinese retaliatory tariffs had the singular purpose of undermining political support for the trade war in the United States and pressuring the Trump administration to rollback tariffs. Chinese tariffs were designed to maximize *leverage* to force the United States to reverse its policy. This meant targeting products produced in Republican-supporting counties, particularly those in closely contested Congressional districts.[21] Over the decade preceding the trade war, China had become the largest importer of U.S. agricultural products. These products tend to be produced in rural districts and states that favor the Republican party and voted for Donald Trump. In response to U.S. tariffs, China levied retaliatory tariffs on almost all U.S. agricultural products, such as soybeans. Other retaliatory tariffs targeted industries such as automobile manufacturing, iron and steel, and oil and gas extraction. In 2019, it even went as far as to instruct its state-owned enterprises to halt all purchases of U.S. agricultural goods.[22]

Researchers estimated that as many as 61 percent of jobs affected by retaliatory tariffs are in counties that voted for Donald Trump.[23] Even so, whereas the EU targeted its tariffs to minimize the harm to its own consumers, China showed no such concern. Rather than acknowledging the underlying issues raised by the USTR's Section 301 Report, which had widespread support in the U.S. business community, Chinese leaders turned the bombast of the Trump administration to its own propagandistic ends by framing the trade

war in nationalistic terms. According to Davis and Wei, leaders in Beijing saw China as an equal to the United States and resented Washington's pressure tactics.[24] This uncompromising approach played into nationalist narratives about U.S. curbing Chinese development. Much of the Chinese commentary in the lead up to the trade war also urged the government to "seek peace through war" (以战争换和平) in the face of pressure from the Trump administration. That is, China should be prepared to place retaliatory tariffs on U.S. exports to counter Trump's tactic of proposing high tariffs and then negotiating exemptions one by one.[25] They perceived a gap between Trump's and the U.S. business community's goals on trade as a source of leverage in U.S.-China trade negotiations. Many Chinese analysts believed the U.S. business community and their allies in Congress would put pressure the Trump administration to stop the trade war from escalating. Thus, as this war of attrition drags on towards a fourth year, both economies are hurt but nonetheless have incentives to hold out until the other side gives in.

V. Short-term Impact: Economic Pain and Uncertainty

5.1 Tariff Impact on the United States

Economists estimate that tariffs have cost U.S. consumers and businesses who buy imported goods $51 billion, or 0.27 percent of GDP.[26] Even after accounting for tariff revenue and gains to domestic producers, the aggregate real income loss was still $7.2 billion, roughly equivalent to the entire annual economic output of a medium sized American city like Topeka, KS or Columbia, MO. Additionally, American importers bore more than 90 percent of the cost of U.S. tariffs[27], putting lie to the claim that China will pay for them. This is because most U.S. importers and could not find new suppliers in the short-run and had little choice but to rely on Chinese suppliers. Instead, U.S. businesses were forced to cut wages, slash jobs, and accept lower profit margins.

Higher tariffs were associated with a 1.4 percent decline in American manufacturing, contrary to exaggerated claims about re-shoring. Trade frictions have also dampened the valuation of listed companies that trade with China and depressed investment in the United States because lower returns to capital weaken incentives to invest.[28] Chinese retaliatory tariffs have also

taken a toll, particularly on Republican-leaning counties that export goods to China. One study estimates that the trade war cost nearly 300,000 jobs between 2018-2019.[29]

A significant portion of these higher costs have been passed on to retailers and eventually to consumers in the form of inflation. Treasury Secretary Janet Yellen has conceded that tariffs are inflationary.[30] Though other factors such as COVID disruptions and changing consumer demand also play a role in inflation, 25 percent tariffs on Chinese goods act as a hidden sales tax that contributes to rising prices in the United States.

5.2 Tariff Impact on China

Tariffs also took a toll on Chinese consumers and businesses. They did so by reducing the volume of trade between the United States and China while incentivizing some countries to reallocate exports into the United States and away from China.[31]

One study found that export-intensive areas of China with the largest U.S. tariff shock saw a 2.5 percent reduction in income per capita between 2018 and 2019.[32] Another study found that Chinese firms that were more exposed to American tariffs posted 3 percent fewer ads and hired fewer workers in the months following tariff increases.

Vortherms and Zhang found that the trade war accelerated foreign firm exit in China, but through elevating political risk more than the targeting of tariffs.[33] Their research reveals that multinationals left China at a rate of 11.4 percent in 2019 compared to an average of 7.1 percent prior to the outbreak of the trade war. The firms that exit are more likely to be smaller and newer to China and not concentrated in manufacturing or information technology that were targeted by tariffs.

Additionally, Chinese consumer prices nearly doubled in the wake of its imposition of retaliatory tariffs from 1.56 percent in 2017 to 2.9 percent in 2019. Prices for popular commodities such as pork more than doubled, a significant enough increase to convince the government to exempt American pork and soybeans (used in animal feed) from tariffs.[34]

5.3 Short-Term Net Assessment

Despite the economic toll on both economies, tariffs have achieved few of

the strategic ends articulated by the Trump administration. They have imposed some costs on Chinese manufacturers yet perhaps more importantly, also have on U.S. manufacturers. Given the evidence of near complete pass through, it is hard to argue that the total economic costs are borne disproportionately by Chinese companies. This makes tariffs hard to justify as an instrument of punishment.

Setting aside the fact that the trade deficit is a flawed measure, tariffs only managed to reduce the trade deficit with China slightly in 2019 before surging to a new record in 2020. Though it is hard to disentangle the roles played by tariffs and by the pandemic in these figures, the undisputed fact is that U.S. tariffs have led to trade diversion from China to countries like Vietnam. The U.S. trade deficit with Vietnam grew alarmingly enough that the Trump administration labeled it a currency manipulator in 2020, hardly a success if deficit reduction was the original goal.

Tariffs have also yielded very limited political leverage for either side. U.S. companies aren't divesting from China as much as U.S. policymakers would like — or pushing back against tariffs as much as Chinese policymakers had hoped.[35] This is because the United States and China are both large domestic markets, so even though the scale of the trade war is immense, the impact on the daily lives of consumers is muted and distant. The rhetoric used by their governments to justify tariffs remain popular with nationalists in both countries, explaining why popular pressure to roll back tariffs have failed to materialize. However, this armed stalemate nonetheless favors Beijing more than Washington because it has given Xi Jinping a freer hand to pursue the same kind of technological self-reliance policies that tariffs were supposed to put an end to.

VI. Medium-term Impact: The Rich Get Richer

Defenders of tariffs might dismiss their high costs and limited success thus far to argue that their strategic benefits will take time to materialize. This sounds like the kind of wishful thinking used to justify the lack of strategy in other wars of attrition such as the ones in Vietnam and Afghanistan. It also leaves unchallenged the faulty logic of economic nationalism that gave rise to the trade war in the first place.

Tariffs harm those who can least afford it while benefiting those industries that least need it. Research by Zhang and Vortherms have found that larger and older multinationals are less likely to close their China operations compared to smaller firms during the trade war.[36] This is why only 4 percent of AmCham China members, who tend to be large multinationals, considered moving out of China in 2019.[37] A similar survey by AmCham Shanghai in 2021 show five-year optimism rebounding, finding that only 1.6 percent of companies plan to move production out of China in the next three years and none planning on relocating production back to the United States.[38] China continues to attract record volumes of foreign direct investment, despite trade tensions and pandemic disruptions. These figures do not suggest that tariffs will produce a sudden change of heart in global business leaders in the future. In fact, foreign multinationals have been cooling on China even before the trade war and have been diversifying their supply chains. They remain in China not because they don't know better but because they are taking a calculated risk to serve China's growing domestic market. These large multinationals also have sophisticated ways to evade or recover tariffs. Instead, tariffs are having an impact on small and medium enterprises in both the United States and China.

6.1 Small and Medium Enterprises are the biggest losers

Neither the United States or China are likely to win from the persistence of tariffs, but the biggest losers will be small and medium enterprises in both countries. These smaller, less productive firms account for a large share of the businesses engaged in trade but a small volume of trade itself. They lack the capacity to find alternative suppliers or hire expensive lobbyists during the trade war. Unlike larger competitors, they also do not have the leverage to pass these costs on to customers or the resources to mitigate them. In other words, even though tariffs affect firms of all sizes, the firm-level capacity to deal with them varies greatly. The most profound effect of tariffs on the medium rung is likely to be within and across countries. For example, aiming to reduce the U.S.-China trade deficit with tariffs ignores the possibility of a larger Chinese firm moving operations to Vietnam through investment and continuing to ship to the United States, while a smaller Chinese firm goes out of business. At the same time, a major U.S. retailer will leverage its supply chains to replace or use its mar-

ket power to pressure Chinese suppliers to eat the cost of tariffs, while a minor U.S. retailer that lacks market power will likely go out of business. Neither the United States or China win here, in both countries it is only the bigger and more global firms that get stronger while smaller ones go out of business.

The popular backlash to trade with China was fueled by a frustration that "Wall Street" benefited more from the relationship than "Main Street." It would be ironic if the smaller firms on main street lose out twice, first by being slow to enter the China market and again by being slow to adjust to the harsher economic realities of tariffs. Furthermore, the creation of byzantine tariff exclusion processes, while effective as a political pressure valve, only exacerbates this problem. Since the introduction of section 301 tariffs, the number and amount of money spent lobbying the USTR have increased significantly. The tariff exclusion process has made lobbyists and their big money clients richer while disadvantaging small businesses.[39]

6.2 Towards a Trade Policy for the Middle Class

Framing the trade war in terms of economic nationalism conceals the true distributional consequences of tariffs. Policy makers in both countries would do well to remember that the winners and losers from trade are often distributed within national borders rather than across them. Rather than letting trade policy be set by a vocal minority who are losers from free trade, the United States should embrace a positive-sum view of trade policy and look out for the aggregate welfare of their respective nations.

A more productive approach would see foreign economic policy as an extension of domestic policy rather than the other way around. Over three-quarters of U.S. managers interviewed in a national survey say that their company has been harmed by tariffs and only 16 percent say that they have been helped.[40] In the same survey, 69 percent of managers say that suppliers have raised prices over the past year as a result of the trade war. Instead of asking Americans to endure tariffs because of some vague notion of economic competition with China, the United States should assess whether tariffs working for the majority of Americans. This approach has several advantages.

First, it would lower prices for businesses and consumers in the face of rising inflationary pressure. The majority or products covered by section 301 tariffs, from medical devices to mattresses to furniture, are not vital to "strategic com-

petition" with China. Furthermore, tariffs are a greater burden on those with lower disposable incomes. Reducing or eliminating tariffs should make many household essentials more affordable for less affluent American households.

Second, it would resonate with a bipartisan desire to make trade work for the middle class. The Biden administration sees the acceleration of corporate consolidation as stifling competition and driving up consumer prices. Tariffs and the tariff exclusion process disproportionate hurt small and medium enterprises that are the backbone of the American middle class.

Third, the trade war reveals that well intentioned government policies to redirect economic flows do not work as intended. This is because businesses are the primary decision makers in trade and they do not always respond to government policies in ways that policymakers intend. U.S. businesses trade with or invest in China not because they are foolish or shortsighted but because makes economic sense to operate there, they have not responded to U.S. tariffs by abandoning China. They also know the risks of operating in China more clearly than policymakers and they should be consulted in crafting foreign policy.

Finally, a bottom-up foreign policy that did not begin with the assumption of zero-sum competition might actually get more done. Politics is the art of compromise. It is easier to agree to disagree on some issues in order to make progress on others such as intellectual property or corporate taxation than to frame compromise as point scoring in some geopolitical contest with China. While this makes trade policy more dramatic, such a frame makes actual problem solving harder. The United States and China have intractable national security concerns with each other but they still stand to gain from cooperation on a host of mundane policies that benefit their interdependent economy.

VII. Conclusion and Recommendations

The U.S.-China Trade War and the widening strategic competition between the two countries are about more than tariffs. But this analysis of how the muddled strategic logic tariffs failed to deliver a good outcome for the United States is a cautionary tale against an all of nothing approach to strategic competition. Tariffs were not a panacea for all the economic challenges facing the United States and righting all the wrongs that China is accused of.

The United States should recognize the economic costs and strategic trade-offs associated with using section 301 tariffs. Research suggests that tariffs are not doing as much as policymakers seem to think in forcing MNCs to choose between the United States and China, nor have they produced the desired macroeconomic outcomes such as deficit reduction. But they have been hugely disruptive and are having a significant distributional impact among the MNCs that operate across the two countries. Tariffs are thus not helping win the competition with China but rather inadvertently creating winners and losers among U.S. businesses that operate in China, with smaller and newer firms losing to larger conglomerates. A trade policy for the middle class is not well served by a regressive tax that passes on the costs of tariffs to those who could least afford it.

Rolling back tariffs does not mean capitulating to China but a change in U.S. tactics. The United States must also reframe the characterization of tariffs as not "tough on China" but bad for the American economy. The Biden administration inherited Trump framing based on flawed economic analysis and mischaracterization of the policy to voters. Indeed, it is remarkable how fast the Belt Way consensus shifted from favoring free trade to favoring tariffs. The lack of leverage may dispel the notion that tariffs are a smart way to compete with China. Rising consumer prices and supply shortages might offer a politically opportune time to reframe the narrative around tariffs.

The United States has at its disposal an array of alternative tools[41] besides tariffs for economic competition with China that may result in less collateral damage on the U.S. economy. Tariffs are a weapon of economic statecraft. But a weapon that is difficult to target and prone harm one's own side is not a very effective one. Any form of economic coercion is a double-edged sword: these tools tend to inflict collateral damage on one's own economy while hurting that of the target, but tariffs are the bluntest weapon of all. U.S. efforts to increase investment in science and technology, to strengthen foreign investment screening, and to add companies with links to the Chinese military to the entities list, all serve strategic competition much more so than tariffs. The United States can continue to safeguard its security interests by investing in its military readiness and working with allies to deter Chinese aggression. It must ignore the siren song of protectionism and remain open to the global inflows of trade, investment, and talent that are at the heart of American competitiveness. Finally, taxing multinational profits or providing subsidies to strategic sectors would both

more directly incentive firm behavior than tariffs. However, the politics of picking which sectors or technologies are strategic and how much to tax MNCs will be bitterly contested in a polarized domestic political arena.

The trade war has made the United States more like China than policy makers may realize, and not always in a good way. Washington has followed Beijing in treating trade and investment as national security vulnerabilities that need to be actively managed. U.S. policymakers are increasingly attracted to the idea of industrial policy. Having long complained about China's manipulation of its economy, the United States demanded that it manipulate trade flows to reduce the bilateral trade deficit in the Phase One Trade Deal. Two years later, China is dramatically short of its purchase commitments because even Chinese officials lacked the ability to bend market forces during a global pandemic. China has also become more like the United States, abandoning its practice of keeping a low profile while striving for achievement in favor of a more openly confrontational foreign policy. This is a recipe for disaster for the world economy.

Leaders in both countries should reflect on the fact that China has gained ground on the United States economically, not by declaring itself to be economic competitors with the United States, but by simultaneously welcoming trade and investment with the world and working tirelessly to give its firms market advantage. Opening and reform lifted China out of poverty not through central planning but rather by allowing for local experimentation, not by treating economic development as a means to some geopolitical end, but as an end in itself. Today, both the United States and China face daunting social and economic challenges at home. The least their leaders can do is to make sure that strategic competition, and the accompanying temptation to weaponize economic interdependencies, do not exacerbate these domestic challenges.

The views expressed are the author's alone, and do not represent the views of the U.S. Government or the Wilson Center.

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