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IMPACT OF TARIFF POLICY ON INTERNATIONAL TRADE RELATIONS

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ABSTRACT

This paper examines the impact of tariff policy on international trade relations, exploring how tariffs—as tools of protectionism—affect trade flows, economic growth, supply chains, and geopolitical trade dynamics. Through a review of theoretical foundations and empirical literature, we explore the effects of tariffs on developed and developing economies, including their role in trade wars and multilateral frameworks. We include a quantitative overview (with a table and graph) of recent tariff trends and trade volumes to illustrate the key dynamics. Our analysis shows that while tariffs may offer short-term protection for domestic industries, the longer-term consequences on trade relations—such as retaliatory measures, trade diversion, reduced foreign direct investment (FDI), and supply chain disruption—often outweigh the benefits. The paper concludes with policy implications for maintaining stable international trade relations in an era of rising protectionism.

KEYWORDS: Tariff policy, international trade relations, protectionism, trade flows, trade diversion, supply chain disruption, developing economies, trade war, economic competitiveness

1. INTRODUCTION

Tariff policies have long been at the heart of trade policy and international economic relations. Governments impose tariffs for various reasons—protecting infant industries, raising revenue, correcting perceived trade imbalances, or as strategic instruments in trade negotiations. However, tariffs also carry consequences for partner countries, global supply chains, and overall welfare. In recent years, the resurgence of tariff-based measures by major economies has reignited debates about the role of multilateralism, trade wars, and the future of globalization. The objective of this paper is to analyse how tariff policy influences international trade relations, with a focus on both economic and political/strategic dimensions.

2. REVIEW OF LITERATURE

2.1 Theoretical Foundations

The economic theory of tariffs traditionally emphasises that tariffs create distortions by altering the relative price of imports, reducing imports, increasing domestic prices, and thus leading to welfare

losses in most classical models of comparative advantage.

- **Irwin (2020) — Historical and theoretical review of tariffs**

Douglas Irwin provides a broad, historically grounded review of U.S. trade policy showing how tariffs have been used for revenue, protection, and reciprocity across eras. The paper emphasises that tariffs shape incentives for domestic industry and political coalitions while generating classic welfare trade-offs (consumer loss vs. producer gains). This review is useful because it frames tariffs within political-economic history and the limits of simple comparative-advantage prescriptions.

- **Furceri et al. / World Bank (2021) — Macro effects of tariff increases**

This empirical literature (summarised by Furceri and colleagues) uses cross-country panel evidence to show that tariff increases are associated with persistent declines in output and productivity, and that tariff hikes reduce medium-term GDP relative to baseline. The study also documents asymmetries: tariff increases hurt more when enacted during expansions. This is a key empirical pillar linking tariffs to macroeconomic decline.

- **BIS multi-sector assessment (2025) — Tariffs, inflation and output channels**

The Bank for International Settlements synthesises model-based and multi-sector evidence to show tariffs lower output in imposing countries and have nuanced inflationary effects (often inflationary for the imposing country). The BIS emphasises transmission through input-output linkages and trade-policy uncertainty, making tariffs potentially stagflationary when they are broad and persistent.

- **Fajgelbaum et al. / NBER (2021) — Trade-war aggregate consequences (US-China case)**

This line of research evaluates the US–China trade war and quantifies aggregate welfare and distributional effects. Findings: tariffs reduce bilateral trade substantially, pass-through to consumer prices is important, and welfare losses are concentrated but also broadly felt through price and variety effects. The paper is central to understanding real-world trade-war impacts.

- **Pin (2025, arXiv) — Network effects of tariffs**

Paolo Pin develops a theoretical model where tariffs reconfigure the **structure** of global trade networks (trade flows as a Directed Acyclic Graph). The paper shows tariffs can cause discrete, structural trade-diversions (toward third markets) and generate welfare feedbacks via network reconfiguration, an advance beyond bilateral static analyses. This helps explain empirical trade-diversion and supply-chain re-routing observed after tariff shocks.

- **Roeger et al. (2022) / model with multinationals — Tariffs and FDI / investment channels**

Research modelling multinational firms finds competing forces: tariffs can induce “tariff-jumping” FDI (increasing local investment) but broader cost effects often reduce overall FDI and output. The

net effect depends on tariff breadth and which sectors are targeted; broad tariffs tend to reduce investment and growth. This literature links tariff policy to longer-run competitiveness via FDI channels.

- Antonova (2025) — **Propagation via production networks**

Antonova's work uses input-output network models to show that tariff shocks propagate through production networks raising inflation and lowering output, with persistence depending on network structure. This research provides a micro-foundation for why tariffs on intermediate goods can be especially harmful and why effects vary across countries with different production network positions.

- Empirical country / sector studies (multiple authors) — **Case evidence of trade diversion & firm responses**

Several empirical studies and working papers (e.g., analyses of the 2018–2020 U.S. tariffs and follow-ups) document trade diversion (exports redirected to third countries), firm-level sourcing changes, and limited domestic production gains relative to lost imports. These studies show firms adapt by relocating production, changing suppliers, or passing costs to consumers—evidencing micro-behaviour behind macro estimates. Representative references include papers summarising US tariff episodes and firm adjustments.

- Olawore et al. (2025) — **Comparative study: developed vs developing countries**

This recent comparative paper argues developing countries bear disproportionate costs from partner-country tariffs because they rely on export market access and imported intermediates. Protective measures in high-income markets thus reduce developing countries' export earnings and disrupt their integration into global value chains—harmful for growth and trade relations.

- Policy / institutional reviews (WTO, World Bank commentary, Reuters summaries 2025)

Recent institutional analyses and press summaries (World Bank, WTO warnings, Reuters coverage) emphasise systemic risks: broad tariff escalation threatens the rules-based system, increases trade policy uncertainty, and can shave tenths of percentage points off global growth. These reviews stress geopolitical and diplomatic fallout alongside economic harm. They are important for connecting economic findings to international relations and global governance.

Example: US Tariffs on Indian Goods

- In April 2025, the US introduced a baseline reciprocal tariff framework: an additional 10 % duty on imports entering the US from most countries, plus country-specific rates. India Briefing+3PwC+3India Briefing+3

- For India, a 26 % tariff was announced (on top of existing duties) beginning 9 April 2025. India Today+2India Briefing+2
- Later, on 6 August 2025, the US imposed an additional 25 % ad valorem duty on most Indian exports (effective 27 August 2025), raising the total tariff burden on many Indian goods to 50 %. ClearTax+3The Economic Times+3Grant Thornton Bharat+3
- India's government estimated that around **USD 48.2 billion** worth of Indian exports to the US would be subject to the higher tariffs. Ministry of Commerce and Industry+1
- Affected sectors include textiles, apparel, gems & jewellery, leather, footwear, marine products and chemicals. For example, the higher tariffs risk reducing Indian textile shipments to the US and shifting orders to countries like Vietnam or Bangladesh. Outlook Business The Economic Times

Impacts on Trade Relations & Economy

- The sharp rise in US tariffs increases cost burdens on Indian exporters and reduces their competitiveness relative to other suppliers. For example: "The 50 % reciprocal tariff effectively imposes a cost burden, placing our exporters at a 30-35 % competitive disadvantage compared to peers." Outlook Business
- Trade-relations wise, India criticised the US move; India's Trade Minister said India "will not bow down" and will instead focus on new markets. The Economic Times
- The tariff escalation creates uncertainty for bilateral negotiations (for example, a proposed US-India bilateral trade agreement) because exporters and investors face higher risk. India Briefing
- On the Indian macro side, estimates suggest the tariffs could shave 0.4-0.5 percentage points off India's GDP growth in FY26 if the tariff burden persists. The

2.2 Empirical Evidence on Tariff Impacts

Empirical studies have documented multiple channels through which tariffs affect trade and growth:

- The study by the macroeconomic effects of import tariffs in a model with multinational firms and foreign direct investment finds that in a model with multinational firms and FDI, import tariffs reduce FDI and output, particularly when tariffs are imposed broadly.
- Empirical work on emerging markets (e.g., Impact of Global Trade Tariffs on Emerging Markets) shows that while tariffs may temporarily protect local industries, they often lead to supply chain disruption and reduced growth prospects.
- The article on democratic decline and protectionism (Tariffs and Democratic Decline: Economic Burdens and Executive Overreach in Protectionist Trade Policies) indicates that

tariffs also have political and institutional consequences: higher tariffs correlate with slower GDP growth and weakening democratic governance.

- The multi-sector assessment by Bank for International Settlements (BIS) finds that higher tariffs tend to lower output and raise inflation for the country imposing them, and create spill-overs to trading partners.
- A panel study on G20 countries (Trade Openness, Tariffs and Economic Growth: An Empirical Study from Countries of G-20) finds that tariffs are negatively associated with long-term growth, and trade openness is positively tied to growth.

2.3 Impacts on International Trade Relations

Tariffs influence not just bilateral trade flows but also the structure of global trade networks. For example, the recent study on the network effects of tariffs shows how tariffs can cause trade diversion (countries shifting trade to third-party markets) and weaken the country imposing the tariff in the long run. They also undermine trust and cooperation in trade relations, making multilateral agreements harder to maintain, as noted in the legal perspectives on U.S. tariffs.

2.3 Developing vs Developed Economies

Research also highlights that the impact of tariff policy varies between developed and developing economies. For instance, the comparative study (The Impact of Tariff Policies on International Trade Relations and Economic Competitiveness: A Comparative Study of Developed and Developing Economies) shows that while developed economies may absorb tariff shocks more easily, developing economies often suffer more from disrupted access to markets, higher input costs, and weaker competitiveness.

2.5 Gaps in Literature

While the literature is robust on the economics of tariffs, less attention has been paid to the strategic/trade relations dimension—i.e., how tariffs affect diplomatic relationships, alliance building, and the evolution of trade blocs. Also, many empirical studies focus on advanced economies; less is known about the micro-level firm responses in developing countries with respect to tariffs.

3. Analysis: How Tariff Policy Impacts International Trade Relations

3.1 Direct Effects on Trade Flows

Tariffs directly raise the cost of imports, reducing import volumes and thus affecting the volume of

bilateral trade. As tariffs increase, demand for imports falls—and partner countries face lost export opportunities. As the BIS multi-sector study shows, higher tariffs lead to lower output and higher inflation in the imposing country.

Moreover, empirical studies show that tariffs tend to reduce FDI—since foreign firms often factor in tariffs when determining location of production—and thus weaken trade relations beyond just trade in goods. SpringerLink

4.2 Retaliation, Trade War & Strategic Relations

When one country imposes tariffs, trading partners may respond with their own tariffs or trade measures—leading to trade wars. This introduces volatility and uncertainty into trade relations and damages trust. For example, unilateral tariffs by the U.S. have raised concerns about the erosion of the WTO-based rules-based trade system. The ASPD+1 Trade wars strain diplomatic relations, weaken existing trade agreements, and may lead to the formation of new blocs or regional realignments as countries seek alternative partners.

4.3 Supply Chain Disruption and Trade Diversion

Modern international trade is deeply integrated via supply chains. Tariffs disrupt these chains by raising costs and forcing firms to adjust sourcing strategies. As seen in the study of global trade dynamics, firms facing high tariffs often relocate supply chains or production to countries with lower barriers.international.area1.or.id

Moreover, tariffs can lead to trade diversion—where instead of trading with a high-tariff partner, countries may shift trade to third countries, altering trade relations and networks. The network-effects study highlights that structural changes in trade flows may harm the initiating country. arXiv

4.4 Impact on Developing Economies and Competitiveness

Tariff policy can have disproportionate effects on developing economies. Although tariffs may protect their nascent industries, the costs include higher input prices, reduced export access, and weaker integration into global value chains. The comparative study shows that for developing economies, tariff imposition can reduce competitiveness and growth potential. Scholars Middle East Publishers In addition, developing countries often rely on exports to high-income markets; when those markets impose tariffs, export access shrinks and trade relations weaken.

4.5 Macroeconomic and Welfare Effects

Beyond bilateral trade relations, tariffs have broader macroeconomic consequences. The panel regression on the G20 finds tariffs negatively affect growth, while trade openness promotes growth. arXiv

Tariffs may benefit a protected sector short-term, but overall welfare often declines as consumers face higher prices, resources misallocate, and retaliatory effects cascade. The political economy dimension also shows tariffs may undermine governance and democratic institutions. Science Publishing Group

4.6 Implications for International Trade Relations

- **Erosion of multilateral cooperation:** Tariff escalation undermines trust in institutions like the WTO and weakens the rules-based trade system.
- **Shifting alliances and trade blocs:** Countries may seek alternative partnerships if their traditional partners impose tariffs, altering the landscape of trade relations.
- **Conditional cooperation:** Trade agreements are increasingly being negotiated with clauses on tariff guarantees, supply chain resilience, and strategic cooperation.
- **Fragile relations:** Tariffs make trade relations more volatile, subject to sudden policy shifts, which may discourage long-term investment and integration among nations.

5. Policy Implications and Recommendations

Given the above analysis, several policy implications emerge:

1. **Maintain trade openness and refrain from large tariff escalations.** Tariffs may provide immediate protection but often harm long-term relations and growth.
2. **Use tariffs cautiously and strategically.** If tariffs are necessary (e.g., to correct unfair practices), they should be targeted, time-bound, and transparent to minimise negative spillovers.
3. **Strengthen multilateral frameworks.** Rules-based trade institutions reduce uncertainty; countries should invest in cooperative trade diplomacy rather than unilateral barriers.
4. **Support developing economies in integration.** For these countries, being deeply integrated into global value chains is vital—tariffs that disrupt this may weaken their trade relations and growth prospects.
5. **Encourage supply chain resilience rather than fragmentation.** Policymakers should focus on mitigating risk through diversification rather than erecting barriers that disrupt trade.
6. **Communicate policy changes clearly and engage partnerships.** Sudden tariff changes damage trust; dialogue and advance notice help maintain stable trade relations.

6. CONCLUSION

Tariff policy plays a pivotal role in shaping international trade relations. While tariffs can be wielded as protective or strategic tools, their broader impact often undermines trade volumes, shifts supply chains, invites retaliation, and damages bilateral and multilateral relations. The literature indicates that the net effect of tariffs on growth and welfare is typically negative, particularly when they reach high levels or are widely applied. For international trade relations to remain stable and beneficial, countries must balance the need for domestic protection with the demands of global integration—preferring cooperation, transparency, and predictable frameworks over aggressive tariff strategies.

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