Intelligence MEMOS

From: Simon J. Evenett and Marc-Andreas Muendler

To: Tariff Watchers

Date: March 28, 2025

Re: **"These Are Your People:" Canada and Mexico Have Retaliation Options that Shrink US Take-Home Pay**

Trade conflict is costly to all parties. Canadian and Mexican trade retaliation can deny tariff-related wins for American workers, we show in our new paper, and go so far as to eliminate all the take-home pay gains in 40 states and make whatever gains occur elsewhere barely noticeable.

Canada and Mexico would take a strong hit from blunt retaliation, but they can use more surgical approaches and demonstrate the limits of Donald Trump's trade policy for US workers.

Soon after his first inauguration in 2017, Mr. Trump contemplated withdrawing from the North American Free Trade Agreement (NAFTA). In a decisive intervention, his Secretary of Agriculture, Sonny Perdue, reportedly persuaded him otherwise, showing evidence that would harm voters especially in red states. Apparently, Perdue's clinching line was: "These are your people."

Now back for a second term, Mr. Trump is back on his tariff track. The economic consensus is that Canadian and Mexican retaliation will worsen the retaliators' living standards. As economist William Beveridge observed long ago about trade restrictions, when a trading partner throws rocks into its harbour it makes little economic sense to block one's own port with stones in retaliation.

Could there be another element in the calculus of retaliation that has been overlooked, leaving aside evident national pride? Our paper simulated the consequences of Canadian and Mexican retaliation, and taking a leaf out of Secretary Perdue's book, we gauged the impact of retaliation on the pay packets of Americans on a state-by-state basis.

We examined two scenarios:

Scenario 1: The United States imposes an additional 25 percent ad valorem import tariff on all goods from Canada and Mexico, except energy products that receive 10 percent levies. China is subject to a 10 percent increase in import tariffs across-the-board. No retaliation occurs.

Scenario 2: Scenario 1 plus: Canada and Mexico retaliate by imposing a 25 percent tariff increase on all imports.

Our retaliation scenario arguably goes beyond what America's trading partners have threatened, but is a plausible choice for policy makers in Ottawa and Mexico City.

To simulate the impact of these scenarios, we deploy the cModel – a computational model of the world that builds in enough granularity to estimate the nominal and inflation-adjusted wage impacts.

In both scenarios real wages fall in all four economies (Canada, China, Mexico and the United States), so from a national perspective no country's workers win this trade conflict, but real wages fall further in Canada and Mexico, which are more dependent on export sales to the United States.

Real-income losses in Canada and Mexico are near 3 percent, they are around 0.5 percent for the United States, and are the smallest for China. Next, we examined the impact on inflation-adjusted earnings in each US state, taking account of their dependence on the Canadian, Chinese, and Mexican markets.

This shows the variation in the impact of retaliation. In six states (Wyoming, North Dakota, Alaska, West Virginia, New Mexico and Oklahoma) retaliation by trade partners does improve inflation-adjusted wages. But there were fewer than 5 million registered voters in these six states – implying that there are 156 million such voters in states where trade retaliation reduces inflation-adjusted real incomes.

The impact of retaliation is starkest when we consider actual nominal take-home pay in US dollars.

Without retaliation, the actual dollar value of wages goes up in every US state – we estimate the gain to typically lie between 1 and 1.5 percent, a clear win for the Trump team. But tough retaliation by Canada, China, and Mexico eliminates the nominal wage gain entirely in all but 10 states, who see only tiny gains.

For Canada, China and Mexico, their residents are their people. No doubt there are smarter retaliation options available that come at a lower cost while still denying the Trump team its win.

These retaliation costs will arguably unfold in the US economy through the mid-term elections next year, so Canadian and Mexican politicians may be prepared to take an economic hit if they find that retaliation increases the likelihood of a backlash against protectionism in these elections.

There is no reason to dispute the old wisdom on the economic inefficacy of retaliation: Clogging your own port with rocks in response to a trade partner's less navigable harbor only does economic harm. However, shift the metric to political gains and losses and the pros and cons of retaliation are cast in a different light. American politicians might want to reflect on the vulnerability of their own voters' take-home pay and living standards. They are their people.

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