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Tariffs and Markups in Retailing*

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Abstract

Tariffs on imported products are typically expected to raise the relative price of foreign goods and, as a result, increase the residual demands of domestic substitutes. In this paper we show, more generally, that these changes in wholesale/manufacturing prices can be offset and even dominated by adjustments in retail mark-ups. Retailers have an incentive to charge the highest mark-ups on the lowest-cost products and to adjust the mark-ups on these products most actively. Thus, if the procurement costs of some foreign products rise, retailers will absorb these cost increases by raising prices relatively more on their relatively more efficient products, thereby mitigating the benefits of a protectionist tariff. We show that this effect can dominate the traditional substitution effect, which highlights the need to better understand the role of retailers in trade policy.

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