THE AUSTRALIAN APEC STUDY CENTRE

Asia Pacific Economic Cooperation

In partnership with RMIT UNIVERSITY

MARCH 2017

Why penalising imports is a bad idea

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Imports matter

The justification for so-called border adjustment taxes and calls for so-called reshoring of production bases are based on a similar argument.

So, should we discourage imports or not?

If we decide that we should discourage imports, policy options would include compressing imports as much as possible while promoting exports, given the apparent contribution of net exports (gross exports after deducting imports) toward gross domestic product (GDP) and foreign exchange earnings.

Think about some developing countries that suffer chronic current account deficits, and which are becoming increasingly vulnerable to external economic shocks with accelerating foreign reserve depletion.

Are imports, then, a necessary evil? The short answer is, not always. In fact, the opposite might be the case. Let's look below the surface. An economy's aggregate welfare is based on the level of individual utility – the benefits an individual can enjoy through economic activities. An individual's utility depends on the consumption level of goods and services.

Income can also be considered when assessing individual and social welfare. But the ultimate goal of earning an income is to use it for consumption. Part of one's income can be saved, but this is simply deferred consumption for future individual or family expenditure.

What does this have to do with imports? Imports are an integral part of domestic consumption. Some imports are also used as a necessary ingredient of domestic investment or as inputs for manufacturing goods to be exported later. We tend to think that imports should be subtracted from aggregate consumption, investment and exports, as they imply a leakage from an economy's GDP.

Subtracting imports in GDP calculations might give the impression that imports are pure leakage, not contributing to an economy at all. But imports are subtracted because they are counted already in other components of GDP like consumption, investment, and exports - and contributed to those components.

Gains may not outweigh efficiency losses

Exports, while inducing GDP growth, can actually be considered foreign countries' expenditure for the outputs produced in the domestic economy. Exports are important, as products not used domestically should be used by foreign economies to shore up the production capacity of the source economy. However, from a national welfare point of view, imports can indeed contribute more directly to the welfare of the recipient economy.

This is why gains from free trade always highlight efficiency gains through a bigger consumer surplus from spending more but at lower costs due to lower import barriers. Furthermore, while higher imports do not contribute to economic growth according to GDP arithmetic, they may already underlie stronger overall consumption, investment and exports in particular during a recovery or an economy's expansion phase, without which further expansion could be constrained.

The exception of course is a mainly import-dependent economy lacking sufficient domestic production capacity. This is why countries at a nascent stage of economic development adopt import substitution strategies to boost certain types of domestic production capacity as observed during the early industrialisation process of economies in East Asia.

But advanced economies need not worry too much about imports. Resorting to 1960s-era import substitution strategies to boost the manufacturing production base and spur job creation reduces an economy's size, and damages domestic welfare through higher costs, inefficient resource allocation, and lost consumption opportunities.

Raising barriers against imports can help improve the terms of trade of the host country at the expense of its trade partners. But those gains may not outweigh efficiency losses incurred, for instance from lost consumption opportunities at lower prices. Furthermore, if trade partners take retaliatory measures, there will be even fewer opportunities for terms of trade gains to materialise.

Proper policy priorities

Skeptics of free trade sometimes argue that imports deprive national economies of domestic jobs and exacerbate current account deficits, which are chronic at some advanced economies like the US. The question is, though, will erecting higher barriers against imports and migration reverse this trend? In contemplating plausible ways to help narrow or close the current account deficit by reducing imports, we can envision two scenarios.

First, an economy could reduce its aggregate demand, including consumption and investment, both private and public. This is because the flip side of a current account deficit is excess national investment over national savings. But it can be difficult for an economy to reduce overall demand without compromising people's quality of life and curtailing investments necessary for economic growth.

Second, aggregate demand levels could be maintained simply by substituting imported goods with those produced domestically. This would sustain quality of life, but require significant expansion of the economy's production capacity. Such a policy could increase savings to the level of investment without curtailing consumption, helping to close the current account deficit.

However, this approach requires greater inputs and higher efficiencies, by mobilising more workers and capital investments, and fostering productivity. Further, higher import barriers constrain the production capacity of domestic firms in the downstream segment of global value chains by raising their input costs and squeezing their profit margins—unless those costs are transferred to domestic or foreign consumers.

Certainly, it would take time for production capacity to grow and its industrial structure to evolve to meet domestic demand. Nonetheless, this approach may be a better option from the perspective of an economy's overall benefits.

As production capacity increases and structural changes ensue, heightened attention to import reduction could be justified without hurting the national economy too much. This is why more infrastructure investment, stronger training and re-training programs, and policies promoting labor mobility are necessary.

However, if an economy continues to prioritise inwardly oriented trade policies without beefing up its own production capacity, the effects could be dire indeed and spill across borders.

This can be hard to prevent, though, if the vested interests of well-organised domestic producers competing with foreign producers are better protected than the interests of consumers. This is frequently the case, as consumers are typically harder to galvanise into an effective lobby.

Global value chains not immune from higher import costs

In addition, penalising imports creates inefficiency and adds costs to domestic producers who rely on imported parts and components for final product assembly or the next round of manufacturing.

This concern cannot be understated. Global value chains are nowadays deep and extremely specialised, with multiple production stages crossing borders. Small- and medium-sized enterprises that are less able to internalise rising costs from import substitution will be the first victims of import penalisation.

Exports certainly contribute to economic growth. But imports are no less important for an economy. If policymakers regard imports as evil, there is little hope of safeguarding free trade and economic and social coexistence. Short-term gains from import penalisation will not guarantee long-term benefits for an individual economy, nor shared prosperity across borders.

After all, it would be ironic if nation-first policies ended up harming the wellbeing of citizens that they were meant to serve.