Syllabus subtopic: Indian Economy and issues relating to planning, mobilization of resources, growth, development and employment.

Prelims and Mains focus: about the import substitution policy and its benefits and how it impacts domestic industries and overall growth of an economy

Context: The recent wave of protectionism and the US-China trade war point to a need to re-evaluate India’s trade policy. The argument in favour of higher tariffs or import substitution is that ‘infant’ domestic industries need to be protected.

Benefit of a low-tariff regime

India’s GDP growth rate has largely gone up over the years with a reduction in tariffs from 1999 onwards.

What is an import substitution policy?

- Under an import substitution policy, a government uses trade tariffs as a policy instrument to encourage domestic industry, the idea being to substitute imports with domestic goods. This policy has been practised by many countries, including India.

- The argument in favour of high tariffs is that in developing countries, industries are yet to develop and, therefore, need to be protected from international trade to ensure their development. This is generally termed the “infant industry” argument and was often cited to justify the policy of tariffs, licences and quotas that predated the 1991 reforms.

Is the ‘infant industry’ argument valid?

- To some extent, the argument is valid as “infant” domestic industries would be hampered by imports of cheaper goods and commodities. But there is adequate empirical evidence, including from India's experience, that
suggests protectionism and tariff barriers act as a disincentive for domestic industries to become competitive.

- Another issue is inputs: a higher tariff on inputs would result in higher input costs for manufacturers, which could otherwise be competitive if they could import cheaper inputs. A comprehensive view of the supply chain must be taken while making any changes to tariff policies.

What has been India’s recent trade experience?

Since 1991, the tariff policy has led to a systemic reduction in India’s weighted effective average tariff, coinciding with a sharp rise in GDP and higher growth rate, even though recent trade experience has been mixed. Several factors are behind the slow pace of export growth. The slowdown has led to a drop in the value of imports, thus shrinking the current account deficit.

Has the reduction in tariffs benefited India?

Many are against imports, but they ignore India’s experience of the last few decades when there was a systematic overhaul of the economy. Lower tariffs have come with higher growth, rise in exports and reduction in poverty at the fastest pace in India’s history. The nation has emerged as a leader in exports of IT services, and is now a key player in pharmaceuticals. As production takes place through supply chains, India has to integrate with global markets to ensure adequate labour-intensive manufacturing jobs.

What about tariffs imposed on exports?

The ongoing trade-war and recent escalation of protectionist steps between the US and China have raised the question about India’s policy response to any rise in tariffs imposed by other countries on Indian goods and services. The high-level advisory group said it would be beneficial for India not to retaliate with tariffs. Any move to raise tariffs must consider the integrated supply chains and the fact that Indian imports are largely for domestic consumption.