RFD 310

Board of Governors of the Federal Reserve System

Division of International Finance

REVIEW OF FOREIGN DEVELOPMENTS

October 28, 1958

A Note on the Treatment of Import Duties in the Measurement of Gross Domestic Product — 4 pages

Robert L. Sammons

NOT FOR PUBLICATION

October 28, 1958.

A Note on the Treatment of Import Duties in the Measurement of Gross Domestic Product.

Robert L. Sammons

It has become the generally established practice in national accounting (social accounting) to make a distinction between the value of output at factor cost and the value of output at market prices. Essentially the difference is the amount of indirect taxes (taxes on expenditure) paid to the domestic government by residents of the country, net of subsidies paid by the government to the private economy. Although the treatment of import duties has not been specifically discussed in the standard methodological works, such as the ones produced by the United Nations and the Organization for European Economic Cooperation, it has been generally understood that import duties were to be treated in the same manner as other indirect taxes. However a variation from this practice has been introduced into the national accounts of the United Kingdom.

Mr. J. L. Nicholson, in an article in the Economic Journal 1/ and in a later note 2/, sustains the thesis that import duties should not be "included" in the total monetary figure representing the value of gross domestic product at market prices, although apparently all other indirect taxes, including those levied and collected at the retail level, should so be included. The later note is a reply to a defense by Mr. H. Burton of the traditional procedure of including all indirect taxes (taxes on expenditure). 3/ In my opinion, Mr. Nicholson does not seem to deal adequately with a basic difficulty, namely, that in trying to measure the value of production at market prices, if this is to be done by economic sectors, there is no satisfactory alternative to including indirect taxes in the value of the output of that sector which actually pays the taxes to the government. Any attempt to use a more refined basis gets into the problem of tax incidence, clearly a matter for analytic investigation and not to be solved by statistical presentation.

The need for having expenditure totals at market prices (including all taxes) for welfare and market analysis is widely recognized. For income and productivity analysis, it is conceded by most authorities that a factor cost (or factor rewards) measure is preferable. However,

---

1/ J. L. Nicholson, "National Income at Factor Cost or Market Prices?," Economic Journal, Vol. LXV, June 1955, p. 216.

2/ J. L. Nicholson, "Import Duties and the Gross Domestic Product at Market Prices," Economic Journal, Vol. LXVIII, June 1958, p. 393.

3/ H. Burton, "Expenditure Taxes, Imports and Gross Domestic Product at Market Prices," Economic Journal, Vol. LXVII, December 1957, p. 644.

in measuring production from the expenditure side, for practical purposes the market price concept can only be applied by product (e.g., automobiles, food, clothing), while the factor cost method of measuring income (or production) can not be applied by product, but only by industry or economic sector.

Some countries do apply the market price measure to output by industrial sector. This they do by subtracting from the sales of each sector the purchases of that sector from all other sectors, both valued at market prices. This is tantamount to including the value of any indirect taxes in the gross output of the sector that includes those taxes in its gross sales figures (or is deemed by the statistician so to include them 4/) and actually pays them to the government.

If this method were applied in the United States, for example, indirect taxes paid by the cigarette industry would be included as part of the output (gross domestic product) of manufacturing (the Federal excise tax, paid by the manufacturer) and of distribution (state taxes, ordinarily paid by the wholesale--or retail--distributor). Actually, the incidence of any tax on tobacco probably falls mainly on the final consumer, in the sense that if the tax were abolished, there would be a substantial reduction in the price of cigarettes. In part, however, the incidence falls on the farmer who grows the tobacco, the manufacturer, and, to some extent, on the wholesaler and retailer who distribute either the intermediate or final product. In part--and this is important--the incidence may fall on the foreign producer of imported tobacco used by the domestic manufacturer, since if all tobacco excises were abolished, the price of unmanufactured tobacco would undoubtedly rise all over the world.

Once the concept of gross product at market prices has been accepted, as the statistical authorities of the United Kingdom do, and as Mr. Nicholson does, there seems to be no logical reason for excluding import duties from the total any more than for excluding any other indirect tax. Mr. Nicholson argues the contrary view, asking: "Since imported tobacco is not part of the net output of the cigarette-manufacturing industry, how can a customs tax on tobacco form part of the gross domestic product of the United Kingdom?" The question is not

---

4/ In the United States retail sales taxes are generally, by law, collected from the customer and remitted to the taxing authority by the retailer. The law imposes the tax on the customer. Presumably in such cases the retailer does not include these taxes in his own accounts; however the economic effect is obviously the same as if a 2 per cent tax on sales were imposed on the retailer and the retailer shifted the tax to the consumer.

whether an indirect tax is in any real or final sense a part of the product of any domestic industry (such a tax if fully shifted to the ultimate consumer would, in one sense, not be a part of the product of any industry, even if all component parts were domestically produced), but whether in some logical or useful meaning of the term it is part of the gross product of the economy. The most useful meaning of the term gross product, it seems to me, is one that will permit adding up component parts and getting a total that equals the sum of all final expenditures in the economy (or by foreigners) on domestically produced goods and services. This can be achieved by summing consumption, investment, and exports (at market prices, which include all indirect taxes paid to domestic governmental entities), and deducting the value of imports (excluding import duties paid to the domestic government), i.e., purchases from abroad.

Mr. Nicholson dismisses the alternative (and to me completely logical) possibility, that customs duties can be regarded as part of the importers' contribution to gross domestic product. He says 5/:

> "It has been suggested that customs duties can, alternatively, be regarded as part of the price of importing the goods in question, and hence as part of the importer's contribution to the gross domestic product. But the customs duty is paid by, not to, the importer, on the goods which he purchases. There can be no case for treating part of the input of an industry as part of its net output. There is, in short, no reason to treat customs duties differently from other indirect taxes."

But Mr. Nicholson does want to treat them differently, by excluding them from gross domestic product! And of course there can be no case for treating part of the input of an industry as part of its net output. Only, it seems to me, inputs can be most usefully regarded as purchases from other businesses or from the rest of the world, not including any taxes that may be levied by the domestic government on the industry making the purchase.

One can agree that if an indirect tax has been paid by the seller and is therefore part of the purchase price, it is not ordinarily included in the purchasing sector's gross or net product, but is deducted along with other intermediate purchases. However, if internal excise taxes paid by the cigarette manufacturer are not to be regarded as "part of the price of purchasing the goods in question," i.e. the tobacco, why should customs duties paid by importers be considered as part of the cost

5/ Economic Journal, Vol. LXV, June 1955, p. 223.

of their purchases from foreigners? Suppose there is an excise tax on raw copper, and part of the transforming industry's supply is imported and part is purchased from domestic mines. Should not the whole excise tax paid be included in gross domestic product? And as part of the product of the transforming industry? And if the tax is a customs duty, and levied on imports only, and even only on imports of completely finished goods, is it any less a tax on the industry (including the distribution industry, which Mr. Nicholson says "is, of course, assumed to be part of the production process") which uses (distributes) the imported good?

The illogical nature of Mr. Nicholson's treatment may be illustrated by a reversal of one of the arguments he uses to support it. He suggests 6/ that, if import duties are included in gross domestic product, the latter will rise (fall) if "we import more (less) of the goods that attract customs duties." (By the way, this would be true only under strict *ceteris paribus* assumptions; actually if there were no change in incomes, either the higher tariffs would have to be absorbed--presumably by reducing profits--along the way, with no resulting rise in gross product, or the total volume of real expenditures reduced.) I presume he would also object to the fact that raising tariff rates on existing imports would also have the effect of increasing domestic product. But suppose that a customs duty were raised or imposed, and that the full effect fell on the foreign exporter, who made an exactly equivalent reduction in his price. The effect of this reduction in price would be to enable the importing economy to obtain a larger amount of foreign goods in exchange for its exports; surely this ability ought to be reflected in an enhanced value of gross domestic product. This statistical result will be achieved only by *not* including customs duties in the value of imports in the equation "Gross domestic product equals consumption plus investment plus exports minus imports" with all terms expressed at market prices paid by the purchasers *to the sellers*, i.e., by *including* customs duties among the items that constitute the difference between domestic (or national) income at factor cost and domestic (or national) product at market prices.

And even if the full effect of the tariff increase were passed along to the final consumer, and the foreign exporter received the same amount of money as before, is it not clear that somebody's "gross domestic product at market prices" has risen? And is it not more logical, or at least more useful, to conceive of the product as having risen in the importing country, whose consumers are willing to pay a higher market price than before for their consumption, than in the producing country, which is not receiving a higher price for that part of its gross product sold to foreigners?

6/ *Economic Journal*, Vol. LXV, June 1955, p. 223.