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# Reforming Trade Tariffs in Bangladesh

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## **Trade Policy and Exports**

Over the past two decades Bangladesh converted its trade policy regime from a near-autarkic one during the 1970s and 1980s to a progressively more open regime. The policy reforms have been focused and comprehensive involving a dismantling of most quantitative trade restrictions and sharp reductions in custom duties. This has served Bangladesh well. Merchandise trade (exports plus imports) to GDP ratio has expanded from 21% in FY1992 to 52% in FY2012. Exports have grown from a mere US\$2.6 billion in FY1992 to US\$ 24.3 billion in FY2012, attaining a heady pace of growth of 12% per year. The ready-made garments (RMG) sector, which has been the leader in the exports boom, alone has created 3.6 million jobs, accounting for almost 60% of total manufacturing employment. Overall, the expansion of exports has contributed substantially to GDP growth, employment and poverty reduction.

The supportive role of trade policy in promoting exports can be seen not only from a simple correlation between the removal of trade barriers and growth of exports but much more convincingly from the experience of the RMG sector. There is a misperception that RMG exports boomed owing to the Multifibre Agreement (MFA) of 1974 that allowed foreign investors to take advantage of the quota space allocated to Bangladesh. While the MFA indeed created the initial space, subsequent growth in RMG was facilitated by a number of important factors of which the bonded warehouse system that allowed duty free imports of raw materials played a critical role. By allowing access to world prices for both inputs and outputs, the trade policy provided a huge impetus to RMG exports. At the same time by dismantling many of the instruments of trade protection to inefficient domestic production trade policy helped lower the disincentive for exports.

There was a fear that the phasing away of the MFA in 2005 will hurt RMG exports. Events have proven the prophets of doom wrong. Contrary to their predictions, the Bangladeshi RMG gained additional market share after the MFA phase-out owing to the inherent accumulated strength of the sector based on productivity and cost advantages. Indeed, with cost escalation in China and India owing to growing labor cost, the prospect for Bangladesh in gaining additional market share of global RMG is bright. To take advantage of this prospect Bangladesh will need to take swift and firm actions to remove some of the emerging constraints, especially the globally explosive issue of worker safety at the work place.

One important question is if trade policy supported the growth of RMG, why is this positive experience not seen in the case of other exports? There are three major reasons for this. First, the full benefits of the trade policy liberalization and its implementation through the bonded warehouse system are not available to most other exports. It is true that custom duties and other import levies are generally low for capital machineries and raw materials and there is also a duty draw-back system, but actual implementation leaves a substantial gap in terms of time and transaction costs (unlike the benefits of a bonded warehouse system). Additionally, the back-to-back LC system available to RMG sector for procuring inputs on credit covered by subsequent export proceeds is also not available to most other exports.

A second reason is that RMG has been treated from its inception as a 100% export oriented industry providing it with a free trade channel as far as tax treatment (duty exemption on exports and imported inputs) was concerned. RMG industry thus operated in a sort of “free trade enclave” within a high and variable tariff regime faced by other exports or potential exports. Thus it rarely suffered from anti-export bias of the tariff regime. Typically, other emerging exports would not be 100% export oriented activities, and had to suffer from lower profitability and anti-export bias of the tariff regime.

Finally, a very important factor is that trade policy is only one element of support for exports. Other determinants include labor skills, technology, foreign investment and skilled entrepreneurs. A critical factor for the success of RMG is the ability of this labor-intensive sector to attract a large number of skilled and talented entrepreneurs who in turn have invested significantly on in-house training of the labor force. Indeed the cost advantage of the RMG sector emerges from the fact that it has very successfully tapped the hugely abundant and low-cost female labor force into an asset by providing them in-house all the training needed for production. This innovative in-house labor training is not a universal phenomenon in Bangladesh. The pivotal role of foreign direct investment at the inception stage is another positive feature that has contributed to the growth of the RMG sector by transferring technology and know-how in production and marketing from the international market place.

Notwithstanding its positive contribution to development, trade policy has come under stress in the past few years. The main pressure has come from the fiscal side. Inadequacy of tax revenues, mainly from income and wealth sources, has caused the government to go back on some of the tariff reductions with the introduction of supplementary duties or para tariffs. This reversal of trade policy reforms is mostly unintentional. The primary motive is revenue collection rather than trade protection based on strategic considerations. Nevertheless, the signal to investors is worrisome. The complex system of multiple taxes and levies (e.g. supplementary and regulatory duties) has resulted in an arbitrary regime of trade protection that imparts a substantial anti-export bias.

This present trade policy is at odds with the manufacturing sector growth and export growth targets set in the Sixth Five Year Plan. There has been limited diversification and exports earnings remain critical dependent upon the performance and prospects in the ready-made-garments (RMG) sector. If Bangladesh were to secure the manufacturing sector and exports growth targets of the Sixth Plan, it needs to ensure that the incentive regime from the trade policy is not biased against exports. While there are a number of important determinants of exports including infrastructure, exchange rate, fiscal policy, direct foreign investment and labor training, the incentive regime from trade policy is of critical importance.

Thus, from the policy perspective, it is essential to make an assessment of the relative incentive regime favoring domestic production and exports. Quantitative assessment of relative incentives could be done by taking stock of the state of effective rates of protection (ERPs) across manufacturing sub-sectors, through an estimation of product ERPs at the firm level – something that has not been done since the launch of the intensive trade liberalization phase in the early 1990s. With these issues in mind, a limited survey of some 100 manufacturing industries was undertaken in May-July 2012, with special focus on firms producing selected consumer goods with potentially high ERPs. The findings of the survey, done on the basis of computations of product-level ERPs for the surveyed firms, were presented as a background report for the

World Bank<sup>1</sup>. This policy brief draws on that larger report and reports the main results. The technical details of the analysis are contained in that report. The policy brief focuses on the implications of the findings for trade policy reforms.

### Structure of Nominal Tariffs

The analysis of relative incentives for exports and domestic sales would have to begin with an analysis of nominal protection to various categories of products imported under the tariff and import tax regime. It turns out that with progressive trade openness, and virtual elimination of trade-related QRs, tariffs on imports are now the single most important determinant of trade protection. Whereas tariffs and quantitative restrictions (QR) together determined the extent of openness or restrictiveness of trade policy in the 1990s and before, the QR slate has been wiped pretty much clean since FY2005, leaving tariffs as the main instrument of trade policy and protection. The tariff structure has been simplified by moving to only four non-zero tariff slabs – 3%, 5%, 12% and 25%. Although the average customs duty has come down over the past 13 years, the average nominal protection rate (NPR) shows mixed trend (Table 1). It initially declined between FY01 and FY09 and then started rising again over FY10-FY13.

**Table 1: Recent Trend in Nominal Protection in Bangladesh**

Fiscal Year	Un-weighted Average CD	Average para-tariff	Average NPR	Top CD Rate	Top NPR*
FY 01	21.10	7.13	28.54	37.5	59
FY 02	21.02	8.11	29.43	37.5	43
FY 03	19.91	6.51	26.42	32.5	52
FY 04	18.82	10.29	29.11	30	53
FY 05	16.31	10.22	26.5	25	60
FY 06	15.49	10.97	26.47	25	72
FY 07	14.85	9.42	24.27	25	69
FY 08	15.93	6.20	21.94	25	72.5
FY 09	13.82	6.26	20.08	25	72.5
FY 10	13.67	10.21	23.88	25	79
FY 11	13.55	10.20	23.74	25	79
FY 12	13.57	13.39	26.96	25	88
FY13	13.87	14.72	28.93	25	108

*Source: NBR Tariff database and PRI staff estimates; (\*) Excludes high NPR on automobiles*

*(Revenue objective dominates), alcoholic beverages, tobacco (demerit goods).*

Two aspects of the tariff structure and its trend are particularly noteworthy:

- (a) perceptible divergence between the top NPR rate (which moved up since FY01) and the average NPR; and
- (b) proliferation of para-tariffs.

<sup>1</sup> Bangladesh Assessment of Effective Rates of Protection, 2012 Survey of Selected Manufacturing Enterprises. Background Report Prepared for the World Bank, Policy Research Institute of Bangladesh

## The Proliferation of Para-Tariffs

These para-tariffs comprise of two taxes: a regulatory duty and a range of supplementary duties.

**Regulatory Duty (RD):** The RD is charged under The Customs Act 1969, at a rate set every year with the budget. However, it has the character of a temporary measure that expires at the end of the year and has to be renewed the following year. The RD rate for FY2012/13 is 5% applied almost uniformly on all products subject to the top rate of 25%, thus making the effective top rate to be at least 30%, if not higher, when SD is applied. The base for computation of RD is the same as CD, i.e. assessable value (AV). For all practical purposes, RD is an additional CD applied on all goods subject to the highest CD rate of 25%. Historically, RD has been applied intermittently, having been eliminated in some years in response to the requirement for simplification of the tariff structure under World Bank's budget support facility, Development Support Credit.

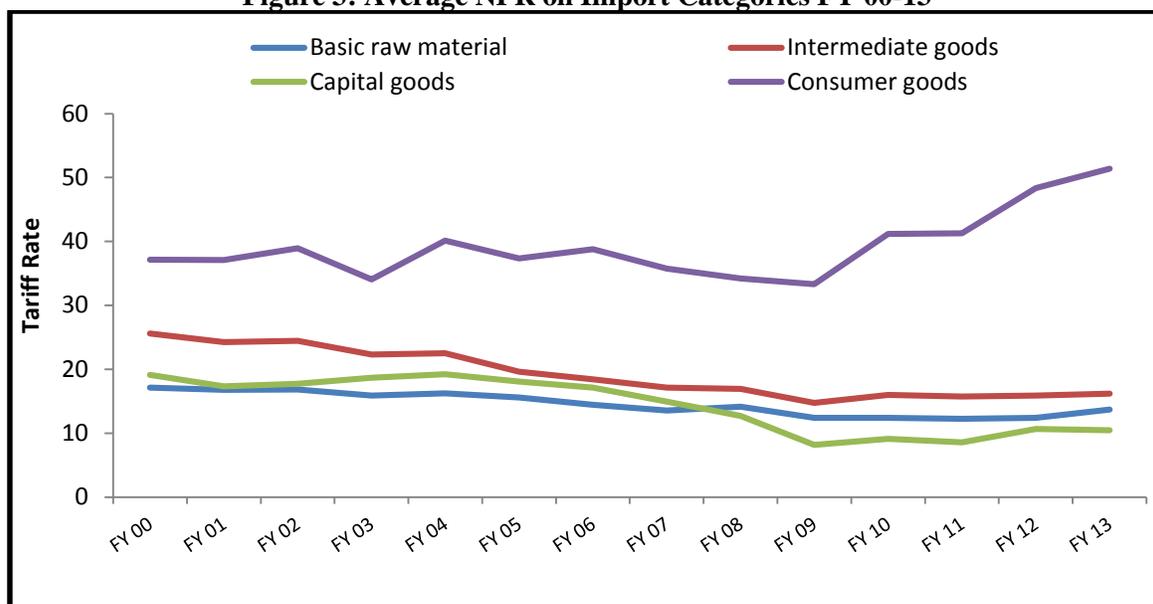
**Supplementary Duty (SD):** SD was introduced in 1991 under the VAT Act, and was meant to be a trade-neutral tax. However, increasingly it has come to be applied in a non-neutral fashion, i.e. it is not applied equally on imports as well as domestic sales. Indeed it has become an expedient instrument of protection through its differential application (higher rates on imports; lower or zero rates applied to import substitutes). Likewise, RD is now seen to be used on an ad hoc basis every year, only on imports, aimed primarily to raise protection to domestic industries, though NBR hopes it will generate extra revenue. The fact that there is hardly any objection from the producer community against these applications testifies to their favorable impact on protection. So far, such rampant use of para-tariffs seems to have escaped attention of WTO Trade Policy Review, since cross-country tariff comparisons available in UNCTAD's COMTRADE database do not have information on para-tariffs. However, information on para-tariffs is being compiled and could soon become an irritant in multilateral trade discussions. The VAT authority also issues exemptions on SD through SROs. SD was applied as a percentage of "*assessable value*" (AV) but, from 1997-98, SD is levied on the basis of duty paid value (assessable value plus customs duty plus regulatory, adding complexity to the computation and creating the scope for malfeasance, which serves as a trade inhibiting factor.

A closer examination of the structure of tariffs reveals that the decline in average NPR was due primarily to the reduction in tariffs on basic raw materials, capital goods and intermediate inputs, while the top CD rate remained flat at 25% since FY05, topped up by generous supplement of levies (RDs and SDs)– para-tariffs. The proliferation of para tariffs has indeed been a major negative feature of the trade policy regime in Bangladesh. Its growing significance is evident from Table 1. Amazingly, it now contributes to more than 50% to the value of the average NPR in FY2013.

A review of the trends in nominal protection rates of import categories (Figure 1) shows that in the recent past the average NPR for input categories have been declining rapidly while that of final consumer goods remained practically flat if not increased. This trend could be symptomatic of the priority demand for higher revenue. But the pressures created by domestic producers of consumer goods seeking higher effective protection by holding on to the higher rates on final consumer goods while depressing rates on imported inputs used in the production process have also had their impact on tariff trends. The net outcome of this process is higher effective protection to domestic producers over time. Also notable are the prohibitively

high NPRs on consumer goods that are domestically produced (e.g. 108% in FY2013). Such high rates, if effective, constitute *de facto* import bans (e.g. biscuits are subject to 200% NPR).

**Figure 3: Average NPR on Import Categories FY 00-13**



*Source: NBR Tariff database and PRI staff estimates*

### Implications for Resource Allocation: Effective Rates of Protection (ERP)

All the protection analysis in the recent past has been done on the basis of nominal protection, which is estimated from the prevailing tariffs and para-tariffs on imports. On an average, we are aware that overall NPR has trended downwards for the past two decades, except in the last few years. But producers know very well that profitability is a function of relative protection on outputs and inputs. They know that higher tariff protection on inputs undercut protection on outputs. Hence, economists have devised an alternative but more precise measure of the incentive to producers arising from the relative weight of tariffs on outputs and inputs. That is the measure of effective rate of protection (ERP). ERP – a measure of effective incentives to a firm producing a traded product – increases with higher tariffs on output or lower tariffs on inputs, and decreases with lower tariffs on outputs or higher tariffs on inputs.

A useful way to think about effective protection is that it is a measure of how much the firm's (or industry's) processing margin is changed from what it would be under free trade i.e. what it would be if nominal protection on both its outputs and tradable inputs were zero. The processing margin is the space into which the producer has to fit the processing costs i.e. labor costs, capital costs including depreciation, interest and profit, and non-traded input costs. A positive ERP has the effect of augmenting the space within which a producer accommodates processing costs. This does not necessarily indicate that all firms can make high profits taking advantage of the tariff-induced augmented processing margin. For an inefficient producer, it might be that most of the processing margin may be absorbed through high labor and capital costs per unit of output. In some industries with a number of firms producing the same or similar products, it is possible that the least efficient marginal firms may be making losses or barely breaking even, while other more efficient ("intramarginal") firms with the same or similar processing margins may be making good profits.

In the case of production for exports, if a firm is exporting but receiving less than full drawback so that its ERP is estimated, for example, at minus 20%, that is indicating that its processing margin on those exports is 20% less than it would be with costlessly functioning duty drawback or SBW system. If it continues to export despite its processing margin being squeezed in this way (as the survey reveals), it presumably is able to cover its labor and capital costs (through productivity enhancements and more cost-effective combination of inputs) and still make an adequate profit. Only the more efficient firms can do that. But if the drawback problem was fixed or ameliorated, or SBW was the norm for exporters, the profitability of export production would improve and it would create the incentive to expand exports relative to domestic sales. Alternatively, if the ERPs for domestic sales in a sub-sector were reduced, exporting activity would become relatively more attractive and one would expect more exports.

A summary of ERP results is shown in Table 1. The ERP computations across products and firms now reveal that effective protection rates far exceed NPRs by wide margins because average input tariffs are well below output NPRs, ranging from over 100% for agro-based products like fruit juice, to over 300% for such products as bicycles and plastic chairs. Barring a few products like carbon rods and jute textiles, which are intermediate products, most of manufacturing in Bangladesh is concentrated on consumer

**Table 2: Summary of Range of ERPs and Average ERPs 2012**

<i>Sub Sectors</i>	<i>Range</i>	<i>Average ERP</i>
Footwear	214%--342%	273%
Jute Textiles	33%--125%	76.5%
Agro-based industry	4.5%--381%	187%
Light Engineering	117%--386%	219.5%
Ceramics	190%--239%	214.9%
Pharmaceuticals	9.4%--20.6%	3.1%
Electrical Products	1.6%--272%	NA
Domestic Garments & Embroidery	5.75%--51%	25%
Plastic Products	86.8%--483%	259.8%

*Source: PRI estimates based on industry survey*

goods production, all of which have output NPR rates between 50-100% (200% for biscuits!). The observed low ERPs for jute textiles are mainly because of redundancy of nominal tariffs due to Bangladesh's strong global competitiveness in this product, while low (barely positive and even negative for some generic drugs) observed ERPs for pharmaceuticals are due to low output NPRs designed by Drug Policy (Drug Control Act of 1982 restricted imports and capped prices) to keep domestic prices low but with strong controls on competing imports which are essentially banned with a view to achieving self-reliance – a goal that was mostly achieved as the country now produced nearly 95% of all drugs demanded locally.

As mentioned before, one of the inferences coming out of the trends in nominal tariffs was the rise in tariff spread, measured by the coefficient of dispersion, which rose from 74% in FY2000-01 to 115% in FY2012-13 – a clear indication that effective rates of protection must be on the rise, as well. Only firm level survey could actually determine what was happening to effective protection to import substitute products. A review of these spreads shows that they are exorbitantly high in the case of import substitute production, particularly for such sub-sectors as footwear, agro-based industries, ceramics, and plastics. Percentage spread range from an average of 470% for footwear to over 1000% for many agro-based products. Spreads

are much lower for the light engineering sectors (e.g. bicycles) and also jute textiles (where effective spreads would be even lower than calculated because protective tariffs are notional). The fact is that all of these sectors have high potential for export expansion, a primary goal of trade and industrial policy. If that be the objective, the incentive system on the ground appears perverse.

Except for jute textiles such as hessian and jute yarn, and an electrical input, carbon rod, the survey has not covered intermediate products because the domestic production base of these products is rather narrow. As observed earlier, average NPR for intermediate goods have been trending downwards since FY01, and is currently around 15%. The industry survey also revealed that the average NPR for inputs was 10-20%. Thus the incentive system, by and large, favors production of consumer goods rather than intermediate or capital goods.

The protection situation is quite the reverse in the case of production for export, even for firms that produce both for the domestic market and exports. Since producers have no output protection in export markets, export ERPs are typically zero when imported inputs are duty exempt via mechanisms such as SBW or duty drawback. Often cash subsidies compensate for duty drawback or SBW. In cases where transaction costs undermine the full extent of duty drawback reimbursement or when there are domestically sourced inputs and cash subsidy does not fully compensate for the duty-inclusive prices, export ERPs could be modestly negative. In the case of footwear and leather, the longstanding export prohibition on wet blue leather – a key raw material for finished leather – serves as a substantial subsidy by keeping domestic price of this key input depressed below world prices, and the resulting ERP could then be significantly positive. All said, export ERPs are found to be zero, modestly negative, or modestly positive.

Thus when relative incentives between domestic production and exports are considered, it is clear that production for domestic sales has a significant advantage over exports. What is disconcerting is that, in a regime of non-uniform tariffs, incentive from protection is non-uniform without any rationale for why some sub-sectors receive heavier effective protection than others. Again, this sort of protective regime reveals significant anti-export bias which raises the question why firms export at all when profitability is so much higher in the domestic market for the same product. The enormous size of the export market, potential scale economies, Bangladesh's labor cost advantage for global competitiveness, and higher revenues from larger sales, all taken together might provide the justification for firms to engage in exports either entirely or in addition to production for domestic sales.

With the exception of jute textiles, carbon rods, and RMG accessories (packaging materials and plastic products like poly bags) which are intermediate products, all other products in this preliminary review were consumer goods which received the highest tariff protection, starting with the top customs duty rate of 25% plus other levies and para-tariffs. As the tariff-setting agency, the National Board of Revenue (NBR), has conformed to a regime of four non-zero tariff slabs, each assigned to a particular import category: 3% for capital goods and machinery, 5% for basic raw materials, 12% for intermediate goods, and 25% for consumer goods, it turns out that most domestic manufacturing being engaged in the production of consumer goods is getting the benefit of the highest tariff slab (supplemented generously with protective para-tariffs such as SD and RD), while the inputs they use are subject to lower rates of duty. In consequence, effective rates of protection afforded to products produced and sold in the domestic market are typically higher than the top CD rate of 25%, and, as observed from the ERP computations thus far, even higher than the nominal protection rate (NPR) on most consumer products domestically produced and sold. For

footwear and ceramics, ERPs range from 190% to 342%; for agro-based and light engineering products, the range is 4.5% to 386%, and so on. There appears to be no recorded policy rationale for the variation; nor does it conform to any stated policy priorities. Hence, the variation appears to be ad hoc.

The support policies for export, such as cash subsidies, and mechanisms to provide duty-free inputs through duty drawback or bonded warehouse facilities, are not enough to match the augmented profitability resulting from generally higher protective tariffs on outputs and lower protective tariffs on inputs. It is important to note that there is no clear evidence that cash incentive scheme has been effective in expanding exports or promoting its diversification. Originally intended to offset tariffs on imported inputs, its widespread use by firms (e.g. jute textiles) with small proportion of imported inputs makes it a wasteful export incentive besides creating the scope for over-invoicing of exports – an avenue for corruption. This practice could also be cited as GATT-illegal by competitors.

Overall, the ERP estimates confirm the existence of significant anti-export bias of the tariff and incentive regime. In these circumstances, it is a fair question to ask why these enterprises export at all when profitability is higher in the domestic market. One answer is that there are positive processing margins still in exports, but processing margins are far greater in domestic sales. Those who recognize the vastness of the export market and future potential can still focus on being competitive in exports to gain greater future sales/profits. In comparison, domestic market is limited and future economies of scale also limited.

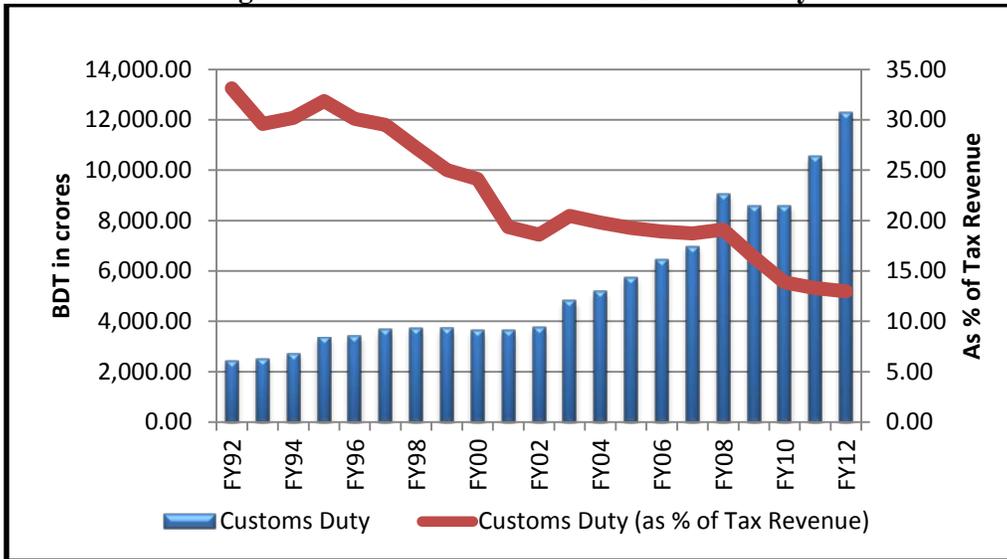
### **Revenue Effects of Trade Taxes**

The main reason for the introduction and rapid expansion of the supplementary duty regime was revenue collection, although lobby from domestic manufacturers for protection may also have played a role. As custom duties were rationalized to bring some order and realism to trade policy, the revenue share of customs duties fell as expected. Revenue collections in nominal terms continued to increase because of a growing import base, but the relative contribution of custom duties as a share of total tax revenues fell.

Figure 3 below includes a historical data chart for Customs duty (CD) collected during FY1991-92 through FY2011-12, showing that though revenue from CD has been rising with imports, its share in total tax revenue has been declining rapidly. Commensurate with the decline in the share of custom duty revenues in total tax revenues, the share of value-added tax (VAT) and income taxes grew. This is a major positive development in the Bangladesh tax structure. Yet, the inability to collect adequate revenues from VAT and income tax sources owing to tax administration problems and also due to many unjustifiable exemptions caused the government to look for easy tax handles. The RD and SD emerged as an easy revenue option.

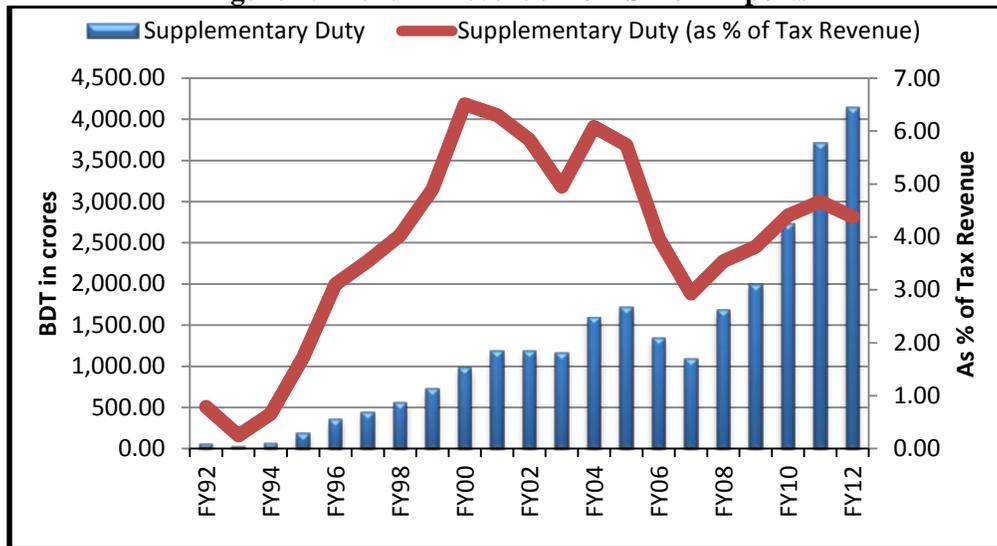
The rampant use of RDs and SDs since the mid 1990s paid little regards to the adverse effects on effective protection and related misallocation of private investment. The almost random ERP results of Table 2 are not backed by any analysis that shows that the protected sectors have provided the basis for rapid manufacturing growth and employment. Indeed, conversely, the un-protected sector, RMG, produced the most positive results in terms of new investment, output and employment.

**Figure 3: Trend in Revenue from Customs Duty**



Source: ASYCUDA Trade Database and PRI staff estimates

**Figure 5: Trend in Revenue from SD on Imports**



Source: ASYCUDA Trade Database and PRI staff estimates

### Implications for Trade Policy Reforms

The policy question is that if such asymmetrical incentives persist, it is difficult to understand how non-RMG exports could expect to reach the kind of heights that was attained by RMG in the global market.

Accelerating growth of the manufacturing sector in Bangladesh will require a combination of adequate energy and transport infrastructure on the one hand and a trade policy regime that is consistent with the functioning of a globally competitive and dynamic manufacturing sector that is also export oriented. The

fact is trade taxes affect profitability of import substitute production on the one hand and export competitiveness on the other with serious implications for trade as well as growth prospects overall and for the manufacturing sector in particular, as this sector is under constant threat of global competition. As the study of both nominal and effective rates of protection reveal, the current trade policy stance, while allowing a free trade regime to the RMG sector, essentially perpetuates the high degree of protection support to domestic (import substituting) industries, at the expense of emerging and potential export industries which are driven to import substitute production due to their relatively higher profitability. Is it sound policy in light of global competitive challenges and Bangladesh's goal of attaining higher growth and reaching middle income status by 2021?

Continuation of this stance might prop up current profitability of import substituting firms, including that of many that might be uncompetitive or inefficient. But import substitute production catering to the domestic market cannot create jobs for the two million people added to the workforce each year. Export production can. Research based on history and global experience indicates that such protection for long periods is bound to create inefficiency and undermine export competitiveness in global markets. We need to reflect if this is the kind of trade regime that will yield the 7-8% GDP growth rate in the medium-term, and 8-10% growth rate over the long-term, as envisaged in the Sixth Five Year Plan (2011-15) and the Perspective Plan (2010-21). International evidence shows that hitherto developing countries that grew at 7-8% rate for a decade were completely transformed from low-income to middle income countries; but their growth record was characterized by open trade regimes -- not the kind of trade regime implied by the existing tariff structure.

High ERPs typically indicate latent inefficiency in firms which tend to perpetuate over time. It is then economically efficient to switch resources away from high ERP (processing margin) activities to lower ERP activities – with consequent increase in productivity and manufacturing growth. In Bangladesh, the way to do that would be to cut the sources of the high ERPs, which in turn means cutting the output tariffs which protect them (especially the para-tariffs) combined with increasing the very low input tariffs. This has the advantage of protecting against revenue losses. Increase in imports owing to reduction in tariffs and SDs will also help revenue growth. Timing of reform is also good because the growth of imports has collapsed and the balance of payments is in surplus.

### **Specific Policy Recommendations to Streamline Trade Tariffs**

- The simplest way of proceeding is to reduce all supplementary duties in a way that the maximum does not exceed 15%. The range could be between 5-15%.
- The maximum custom duty could be lowered to 20% while the minimum should be raised from 0-3% to 5%. There can be only a few exceptions (zero rate) to the 5% rule that may include staple food and medicines only.
- Items that have import duties between 5% could be increased to 12%.
- Abolish the regulatory duty.
- The above have the advantage that not only ERP will be lowered this will also help protect against revenue losses. Increase in imports owing to reduction in average nominal protection from tariffs and SDs will also help revenue growth.
- Timing of reform is also good because the growth of imports has collapsed and the balance of payments is in surplus.