Are we bracing for a ‘protection shock’?

Sunday, May 28, 2017

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This is truly the eleventh hour. The i’s have been dotted, the t’s crossed, and the budget document is all but ready to be placed in parliament on June 01, 2017. For all the pre-budget facts and rumours circulating, every budget has its share of surprises. This one will be no different. The hope is that budget surprises don’t turn into a shock for the business community. I am of course referring to the launching of much delayed Value Added Tax (VAT) and Supplementary Duties (SD) Act, 2012 which now appears to be a fait accompli — a certainty. What is uncertain is whether the Law will be applied as is or with some adjustments. The Honourable Finance Minister has spent long hours in the past month preparing the grounds for the hard landing as it were. And the business community is gearing up to live with the consequences, though not without the predictable resistance that such a major change in the tax law and its modus operandi brings.

The application of the Law is expected to bring systemic improvements in the VAT regime by eliminating many distortions that have crept into the VAT imposition and collection process that all but negates some of the core principles of taxing value addition in economic activity. Given the assumption of widespread evasion of VAT the revenue authority is preparing itself for a serious effort to expand coverage and mobilise significantly higher revenue from the most productive tax source. There will be significant changes in the tax base via elimination of truncated base and tariff values (pre-assigned values) which will have impacts on revenue collection from the VAT system. Not surprisingly, the focus of the business community seems to have centred on the VAT rate (of 15 per cent) and pressure is mounting on the Finance Minister to reduce the VAT rate.

There seems to be much less attention paid to what might be called the protection implications of the new VAT law. The cardinal principle of the VAT system is its “trade neutrality”, meaning that it is applied equivalently on imports and substitute domestic production. That is how the 15 per cent VAT is currently applied on imports as well as their domestically produced substitutes, so that the effective trade protection from VAT is zero. SD on imports was first introduced under the VAT Law in 1991, on the same principle of trade neutrality. However, as we all know, over time SD became a handy instrument with the revenue authority to accommodate protection pressure from import-substituting industries.

The way the current tariff structure is laid out, a big portion of the protection comes from Supplementary Duties applied to tariff lines representing final consumer goods which comprise the bulk of production of import substitutes in the domestic market. Instead of applying equally on imports and domestic production, the predominant tendency has been to apply SD on imports only, or at a higher rate than on domestic production, leaving a substantial measure of protective SD. Policy Research Institute (PRI) research shows that out of the 1532 tariff lines subject to SD, 1458 have SD on imports only, and 58 have higher rates on imports (Table 1). By and large, SD thus becomes a para-tariff used primarily as an instrument of protection. All the highly protected import substitute products have the benefit of SD on imports. Not surprisingly, I have never heard a complaint about SD on imports being too high.

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PRI research shows that the current scheme of SD distribution has the effect of imparting roughly one-half of nominal protection to import substitute production through a plethora of SDs. Applying these SDs on top of 25 per cent customs duty (CD) gives quite a few domestic import substitutes significant protection for a long time. With input tariffs (on basic raw materials, intermediate goods) averaging about 11.5 per cent, the effective protection level for most of these products reach 200-300 per cent. How the application of the new VAT Law will impact protection will depend largely on what adjustments, if any, are made to the “protection” structure in the final budget proposals. A cursory review of the impact on nominal protection rates of some of the highly protected products reveals a substantial reduction of protection with the application of the new Law (Table 2).

The new VAT Law proposes to eliminate SD in 1234 out of the 1532 tariff lines. This massive elimination of supplementary duties applied predominantly at the import stage as well application of remaining SD on a trade neutral basis will also certainly improve the structure of the VAT system towards trade neutrality, and improve transparency of the import tariff structure. But the move will also lead to drastic erosion of the high degree of protection offered to domestic products implicitly through the uneven application of supplementary duty. Our estimates show that for some of the top protected import substitutes, the new Nominal Protection Rate (NPR) will be down to only 28 per cent (CD=25, RD=3) from as high as 156 per cent for non-alcoholic beverages. Should the new Law go forward ‘as is’ the only protective tariff remaining would be CD and RD (Regulatory Duty). Of course, the actual reduction will depend on what SD distribution the fiscal year (FY) 2018 budget lays out. While the move is exactly what the doctor ordered, is the drastic reduction of protection in one go actually “intended”?

I have argued so many times in these columns that our policy of high protection ad infinitum is not helpful in achieving international competitiveness or creating the millions of jobs needed to lift our people out of poverty. In so far as trade policy is concerned the ‘protection challenge’ has been the elephant in the room since independence. In recent times the focus on export-oriented manufacturing growth has further brought the protection issue to the forefront. Because high protection for import substitutes and export expansion and diversification are two goals that are not mutually exclusive. They are in sharp conflict with each other because protection raises relative profitability of sales in the domestic market over that of exports. So we can’t say in one breadth that we want exports to flourish and be diversified while at the same time doggedly clinging to a regime of high protection. Something has got to give. And rationalization of the protection structure was long overdue.

Having said that it was never our expectation that this rationalisation could be done in one go without causing serious dislocations in the hitherto protected sectors. A phased transition from ‘high’ to ‘moderate’ and ‘low’ protection with a pre-announced timeline would be the ideal approach to this policy challenge that has been brewing for a long time. The political economy of scaling down protection is just as critical as the associated economic rationale.