Need for a more Export-friendly Tariff Regime

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Export performance in the fiscal year just ended has 'export resilience' written all over. As I predicted few months ago, exports were on the verge of meeting EPB's cautious target of 13% growth. As it turns out, actual performance fell barely short of the target – missing by only one percentage point. Though hardly a cause for celebration, that should bring some relief to the folks at Export Promotion Bureau (EPB) and the exporter community.

A quick take on the year's export performance reveals some useful pointers for all concerned to take note of. First, exports reached the figure of $30.2 billion, growing at 11.65% over FY2013 exports of $27 billion, and falling about 1% short of a target growth of 12.85% — a rather cautious target set in light of the anticipated political storm. Second, 96% of our exports are characterized as manufactures; the remaining 4% are agricultural products. Third, RMG exports, at $24.5 billion, made up 81% of total exports, and grew by 13.8%, against a target of 12.2%. Knitwear component of RMG exceeded target by 4%, while woven garments fell short of target by 1%. The sector showed utmost resilience against heavy odds and dire predictions about order cancellations or diversions in the wake of Rana Plaza episode followed by political turmoil. Fourth, though nobody talked about order cancellations or diversions in the case of non-RMG exports, it appears that the political turmoil took a

heavy toll on non-RMG exports, which ended the year showing an anemic growth of a paltry 3.1%. Fifth, the lone star performer in the non-RMG category was footwear which, at $550 million, clocked a notable 31% growth on the back of an average 25% annual rate over the past 5 years. In FY2001, footwear exports were a mere $25 million. If anybody is searching for the next RMG, this is the one sector to watch. Home textiles did not do well this year but, having registered upward trend over a decade, would be another product to watch. Finally, surveying EPB's summary report on exports for FY2013-14 reveals a number of other product groups that registered similar or much higher growth rates, like furniture, glassware, ceramics, umbrella, but a review of their export trend for the past ten years shows erratic swings across years without a marked upward trend. Exportsthat continued to disappoint were computer services, oceangoing vessels, electric products, jute and jute goods.

The divergent performance of RMG and non-RMG exports is worth some introspection. If RMG exporters could weather the storm to end the year on a solid note, what was lacking in non-RMG exporters? To put the entire blame on political turmoil would be disingenuous since the crisis did not discriminate between exporters. A little soul searching, I think,would point to the prevailing differential incentive system as being responsible for the poor performance of non-RMG exports. Except for oceangoing vessels that suffered due to order cancellations in view of the protracted economic crisis in parts of Europe, most non-RMG exports, I would argue, operate under tariffs and an incentive system that is inimical to exports when compared to domestic sales. A complex and unfriendly tariff regime is a significant part of that system.

Tariffs and para-tariffs are imposed on imports and the standard discussion in policy circles has centered around their effects on revenue or protection to domestic industries. In so far as exports are concerned, the narrative is limited to the cost implications of tariffs on inputs for export production, a situation that has been addressed by the duty-drawback system which, for all practical purposes, is dysfunctional, being tainted by incompetence and corruption all the way. Exports, to be competitive in world markets, must have access to inputs at world prices, i.e. upfront duty-free inputs. This is not a privilege but a basic requirement for placing our products in world markets at competitive prices. Our duty-drawback system is not the answer.

But that is not the only problem faced by producers of exportable products. They have a

choice: to produce for the domestic market or for exports. And, given our tariff regime, the profitability in the two markets is not the same. This is where RMG producers are in a different league altogether. Since its inception it was officially recognized as a 100% export-oriented sector and was allowed to import all its inputs duty-free. Why? Because of the high tariff regime and bans/restrictions on imports, there was no way this industry, which epitomizes Bangladesh’s comparative advantage in labor-intensive manufactures, could get off the ground and sell its products at competitive prices in world markets, even under cover of the Multi-Fiber Arrangement (MFA). True, the MFA opened markets for countries like Bangladesh but it did not guarantee sales unless its exports were competitive in terms of cost and quality. It is the combination of duty-free imported inputs, credit facility for importing inputs with export proceeds, and initial technical and marketing advice from foreign investors that contributed to the spectacular success of this industry. The rest is history. Bangladesh is now one of the leading exporters of RMG in the world. But labor-intensive production is not limited to readymade garments. There are numerous manufactured products traded around the world that can be produced at competitive costs in Bangladesh for world markets, very much like RMG. Where is this mono-product bind coming from?

For starters, RMG producers do not face a choice between domestic sales and exports. Other exporters and potential exporters do. And what do they find? The tariff regime is such that the production and domestic sale of import substitute products, particularly consumer goods, are not only protected from import competition but because of the protective tariffs profitability is significantly higher from domestic sales than from exports. In the case of exports of footwear or automobile batteries, for example, domestic prices are propped up significantly above international prices by protective tariffs. Whereas average protective tariffs on consumer goods is about 51%, effective protection (read profitability) on most consumer goods is raised through a process called tariff escalation by maintaining substantially lower average tariffs (13%) on inputs. When exporting these products to developed country markets or emerging market economies, prices they can fetch are typically close to international prices not to mention the fierce competition from other suppliers. Thus in export markets profits have to be earned by being cost competitive whereas in the domestic market they can afford to be complacent. To gain market access for exports and retain it for the long-term requires exporters to be on their toes. Markets lost are hard to recover. Ensuring a highly protected domestic market with profits propped up by

tariffs breeds complacency and inefficiency. In other words, non-RMG exporters lacked the fire in their bellies that was the driving force for RMG exporters.

To cut a long story short, unless we address the vital issue of relative profitability of exports versus domestic sales, non-RMG exports will remain constrained probably basking on the glory of an expanding domestic market that in the ultimate analysis is miniscule compared to the size of the world market. While policymakers and exporters are doing their best to open new export markets and seizing opportunities for preferential access, one critical element missing in the strategy for export expansion is the proper aligning of the tariff regime to make export production just as attractive as production of import substitutes. The current tariff regime is simply unfriendly to non-RMG exports. The challenge is vast because of the prevailing high protective tariffs. But a start has to be made now by scaling down the top heavy tariffs on consumer goods while squeezing the gap between output and input tariffs in a concertina approach. Intermediate goods production has also been largely discouraged by secular decline in their protection. We can ill afford to reduce those tariffs any further without first scaling back the top rates on consumer goods.

Theoretically, the most neutral tariff regime of course is a zero tariff regime. The next best thing would be a low but uniform tariff regime. Chile is the only country in the world that can claim a uniform tariff structure where all input and output tariffs average about 6%. Such utopian schemes might be out of our league, but unless Bangladesh starts the process of eliminating anti-export bias of the tariff regime, we can only be sure of seeing further export concentration in RMG while the dreams of export diversification fade away.

It is time we recognized that exports are and will continue to be the driver of jobs and growth. With two million job seekers entering the workforce every year, creating jobs for them in addition to reducing the backlog of disguised unemployment or underemployment are challenges that policymakers will have to grapple with if Bangladesh is to make the best of the demographic dividend stemming from a large and growing working age population. True, our economy is growing at a steady pace. Yet, the domestic economy is far too limited in size to generate the kind of demand growth that can fuel job creation of 20 million additional workers in a decade. Export markets can. Our leading export sector (RMG) has shown the way. Footwear could be the next RMG with similar job creation potentials. Do we have our policies right?A more export-friendly tariff regime should be a top priority.