

## Rationalising the Protection Regime

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In 21st century Bangladesh citizens can really be proud of a lot of stellar achievements in human and material progress. Sadly, a dynamic and modern trade policy is not one of them. That is because we are still beholden to an idea that is a 1960s concoction that is as obsolete as the vintage black and white TV. I am talking of course about protection to our not-so-infant manufacturing industries (e.g. biscuit manufacturing).

The policy of protection ad infinitum has bred a lot of geriatric infants. While in the last fifty years, so many developing countries dismantled their protection regime in favour of trade openness and export orientation, trade policy reforms in Bangladesh appears to have stalled after an initial burst of trade liberalisation in the 1990s. Under the auspices of the General Agreement on Tariffs and Trade (GATT) and World Trade Organisation (WTO), the world has moved on after the first generation reforms in tariffs and trade, to now address second generation trade reforms dealing with behind-the-border issues such as competition, payment systems, and trade facilitation.

Sadly for Bangladesh, the first generation trade reform agenda remains incomplete as the economy remains mired in a high tariff protection regime from which it is yet to come out. Is this protection regime compatible with 21st century Bangladesh? Is it creating employment and growth? If not, the forthcoming fiscal year (FY) 2016-17 or, FY2017, budget offers yet another opportunity to address the challenge of rationalising our protection regime, step by step.

First, let us take a snapshot of the state of our protection regime. True, we have come a long way from the pre-1990 days when imports were widely controlled with quantitative restrictions (QRs) and prohibitively high tariffs (some 40% of tariff lines in 1990 were subject

to customs duties of 100% or greater). In the early 1990s, under a structural adjustment programme supported by World Bank-IMF, the economy embraced trade liberalisation reforms on a significant scale that saw not just reduction of tariffs and removal of quantitative restrictions, but also included moving from fixed to flexible exchange rates, convertibility of the current account, and elimination of the 'license raj' in imports.

The underlying theme of these reforms was to resurrect the trade regime from an inward-looking stance to an outward-looking export oriented strategy. Though many sectors were hit by the inroads of import competition, the apprehension expressed by many that trade liberalisation would result in deindustrialisation of the economy did not materialise. Exports did get a boost though much of it came from the dynamic readymade garment (RMG) industry, which was set up as a 100% export oriented sector, with all the trappings of a free-trade regime.

Reviewing protection trends during the course of the past twenty five years is instructive. While a combination of QRs and tariffs were the mainstay of protection, as we embarked into the 21st century, the QR slate was pretty much wiped clean, leaving tariffs (and para-tariffs) as the main instruments of protection. One indicator of the overall level of protection is the nominal rate of tariff, called nominal rate of protection (NPR). For any particular import substitute product produced locally, the tariff on import of the same product acts as an indirect subsidy (support) because the tariff helps to prop up the domestic price by up to the rate of the tariff.

We need to distinguish between NPR and total tariff incidence (TTI). Instead of imposing a simple tariff such as customs duty on imports, National Board of Revenue (NBR) follows a tradition of imposing several types of import taxes, some of which are trade neutral (imposed equally on imports and domestic production, such as VAT) while others (e.g. regulatory duty or RD) are not. While NPR excludes trade neutral component of import taxes, TTI measures the overall import tax incidence. NPR is a protection indicator while TTI is a revenue indicator. While average NPR declined sharply during the 1990s, from 73% in FY1991-92 to 37% by FY1994-95, and to 29% by FY1999-2000, strongly signaling substantial reduction in protection from earlier years. But then the decline seems to have stopped, remaining practically stagnant between FY2000-01 and FY2012-13 (Table 1), at around 29%. The last three years has seen some downward movement reaching 25.6% NPR in FY2016.



While Bangladesh was reducing tariffs over two decades, its comparators were reducing even faster such that by 2014, least-developed country (LDC) tariffs averaged 12%, while low and middle income countries averaged 7.0%, far below those of Bangladesh. However, average NPR masks the actual degree of protection meted out to domestic import substitute producers. Looking at the top NPR rate is more indicative of the level of support. It turns out that most if not all manufacturing products that are domestically produced are subject to the highest NPR rate. The highest NPR rate rose from 59% in FY2000-01 to 108% in FY2012-13, receding a little to 87% in FY2016.

At present the products with the highest NPR include biscuits, toiletries, furniture, footwear, glassware, ceramics, fans, and electric lamps. Surprisingly, even RMG which needs no protection is subject to the highest NPR. The next highest NPR rate is 72%, given to fabrics and sanitary wares. So essentially any product (mostly final consumer goods) that is produced domestically has been given the highest NPR treatment, with the result that domestic consumers are essentially paying prices around 70-100% above world prices for these products, imported or produced locally.

The matter doesn't end there. Nominal tariffs are only the tip of the iceberg. The effective rate of protection is the outcome of a combination of tariffs on output (consumer goods) and tariffs on inputs (intermediate goods, capital goods, and basic raw materials). Tariffs on output raise profitability, tariffs on inputs raise input prices and lower profitability and effective protection. So given the choice and scope, domestic producers would like to see tariffs on output to trend upwards, and tariffs on inputs trend downwards, over time. A look at tariff trends on output and input give a picture of exactly what import substitute producers desired (Table 2 and Fig.1) and policymakers conceded. So where is the problem?

One question that should come to mind is how much protection is reasonable and how long should such artificial support (which clearly is at the expense of the ordinary consumer) last? In Bangladesh, for some industries, protection has lasted for 50 years or more (e.g. biscuit industry). And it still commands the highest rate of protection. In the 21st century, is it not high time to make protection time bound? Let producers and consumers know how long the protection support will last. Yet, the policy we have all come to accept is that protection is

here to stay and more is good.

However, a serious policy dilemma that is emerging is whether to persist with high protection of most import substituting industries or focus on export orientation. The two policies are not mutually exclusive because protection has a built in anti-export bias that gets stronger higher the rate of protection. How? For industries that produce for exports as well as domestic sales, while tariffs raise profitability of domestic sales, there is no way of raising export prices which are determined by global supply and demand. Hence, tariffs raise the relative profitability of domestic sales compared to exports, thus discouraging production for exports.



So policymakers face a choice particularly for the burgeoning import substituting manufacturing sector that also produces for exports (non-RMG). The policy dilemma emerges because of the need to fuel an export boom in order to scale the heights of 7.0%+ GDP (gross domestic product) growth, a feat that is only possible by getting manufacturing exports (non-RMG) to grow by double digits for a sustained period. The Seventh Five Year Plan (FY2016-2020) expects manufacturing growth to average 11%+ over the next five years. That requires superior export performance with sustained double digit export growth because export production make up about 50% of total manufacturing production. Is this possible while maintaining high protection levels to domestic import substituting industries? Historical and cross-country evidence suggest this is not possible without a rationalisation of the protection regime which, in the Bangladesh context, requires scaling down, step by step, the high NPR on consumer goods.

While rationalising protection has become a national imperative, make no mistake, the stakes are high, and expected resistance will be enormous. Columbia University trade economist Jagdish Bhagwati once remarked that "...even if protection were appropriate in theory, it would be "captured" in practice by special interests who would misuse it to pursue their own interests instead of letting it be used for the national interest." Which is why a step by step rather than a big bang approach will be appropriate in Bangladesh.

Let us accept the fact that policymakers face daunting challenges in their effort to rationalise the protection regime. Yet it is high time to get started. A few short steps in the right direction were taken in the past three years by scaling down the top NPR from 108% to 87%. Continuing that trend in the FY2017 budget will be necessary. Key stakeholders should be kept informed and advised to embrace change, for the long-term competitiveness of their industry, and to boost manufacturing productivity in 21st century Bangladesh.