Reminiscing industrial protection: No end in sight

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The theoretical argument for protection presupposes a timeline at the end of which protection

to any economic activity is to be scaled down or completely eliminated. The most popular argument for protection used to be known as “infant industry” protection. The argument was simple and seemingly very convincing to the lay person. Like infants, start up industries cannot compete with established enterprises, so they needed to be supported with all kinds of tariff and non-tariff protection or subsidy, The most popular instruments of protection used to be the application of bans, restrictions, or high tariffs on import competing products thereby creating a protective wall for import substitute production for sale in the domestic market. The underlying rationale was that once infants had time to grow up and stand on their feet, as it were, protection would no longer be necessary and tariffs or import restrictions could be scaled back. The idea of protection gained traction in the 1950s and 1960s through the writings of two economists, Raul Peribisch and Hans Singer, who postulated that developing countries would lose out in the long run if they continued to produce and export primary commodities leaving developed countries to produce and export all manufactured goods. This became known as the Peribisch-Singer hypothesis which provided the rationale for protection to start up manufacturing industries in developing countries through tariffs and restrictions on manufacturing imports which, in those days, mostly came from developed countries. All this would be nice if protected industries would grow out of their initial handicap and become competitive with imports so that protection could be scaled back. However, historical and cross-country evidence soon revealed that by the 1980s the world had become littered with “geriatric infants” who failed to grow out of their infantile character and continued to need protection indefinitely. Consequently, in economics literature, the infant industry argument lost its initial appeal and was discarded by trade economists as a valid argument for industrial protection. In its place came a theoretically more sophisticated argument that protection to start up enterprises was justified only in the case of “decreasing cost” industries, i.e. those with potential comparative advantage which face high cost of production at the start but will eventually be able to lower production costs through learning-by-doing and become competitive with imports, at which time protection (through tariff or otherwise) could be scaled back or eliminated. This is also the rationale for protecting import substituting industries with potential comparative advantage, in the hope that they will one day become globally competitive export industries. Nowhere in this argument does it say that ad infinitum protection was okay. What is equally disconcerting is that theory leaves no hint as to what the optimal period of protection should be. That leaves policymakers, who are not necessarily economists, the option to make their own judgments about the period that protection would be granted to an economic activity,

such as a manufacturing industry. In practice, it appears from cross-country evidence, including Bangladesh, that the ‘period’ question has been largely ignored with the result that protection once granted has had a tendency to perpetuate itself. Those firms that sought protection in the first place are seldom to be the one to press for scaling down of the same. Leading trade economists of the world (e.g. Jagdish Bhagwati, Anne Kruger) who studied the record and practice of protectionism around the world found that recipients of protection spent a lot of time and effort and incurred costs in order to retain protection once given. But research (and logic) also revealed that protection continued for too long generates complacency undermining incentives to improve productivity or competitiveness with global players. The classic example often cited is that of the Indian Ambassador car which did not change its model for 50 years due to a fully protected market with long lines of buyers eagerly waiting to get their hands on the wheel of an Ambassador in a market completely devoid of foreign-made cars. Bangladesh film industry is yet another example of what prolonged protection does to quality of a product. This industry has very little to show for despite many decades of ban on Indian movies, so much so that Bangladesh is have been staying away from movie houses in droves with the result that a large number of cinema halls are being turned into shopping malls. As an economic policy, the issue of protection raises a whole host of questions for which answers me difficult to come by. Assuming it is possible to identify products or firms with potential comparative advantage to be able to become globally competitive in the foreseeable future, how much protection would be needed? 50%, l00%, 200%? Are all products going to be equally protected through some kind of uniform protection? If not, how do you decide which products will have higher protection and in what way do you rank products for higher or lower protection? And then, of course, there is the question of how long protection is expected to last. Answers to these questions are not clear from theory or empirics of trade protection. The only plausible answer offered by some economists is the case for uniform tariff protection that can be accorded through one uniform rate of tariff on all imports – an almost impossible feat, though some developing countries (e.g. Chile) did try experimenting with something close to a uniform tariff. With non-uniform tariffs, it is impossible to guess the level of effective rates of protection (ERP) to any firm or sector since that is a function of value added. In fact, ERP is inversely related to value added generated: lower the value added for a given spread between tariffs on output and input, higher the ERP, i.e. higher the profitability! More often than not, the strongest proponents of protection are found to invoke the political economy route of nationalistic sentiments. “Made in Bangladesh” has mass appeal of a different sort where consumers me

willing to opt for locally made products over imported ones regardless of quality. Policymakers and producers/investors could also make the argument that protection is good because it creates or saves domestic jobs, saves foreign exchange and improves balance of payments by substituting for imports, creates indigenous entrepreneurs, and contributes positively to gross domestic product (GDP). All this sounds good, but there is no mention of the timeframe at the end of which protection is to be eased out. How long is not too long is then an obvious question that comes to mind but is conveniently ignored in this line of reasoning. To be sure, protection to domestic industries by way of tariffs or import restrictions comes with a baggage of costs, a matter that is seldom raised in the popular discourse. Tariff protection is an indirect subsidy to the producer of an import substitute and a tax on the consumer because, as a consequence of the protective tariff, the consumer ends up paying a higher price for the import substitute than he would have paid if there was no such tariff. The extra tariff-induced price that the consumers pay ands up with the producer while the revenue from tariff goes to the government. The only loser then is the consumer who also suffers from less product choice resulting from the tariff-induced restriction on imports. What is little understood and even less discussed in policy or business circles is that protection becomes a medium for the transfer of resources from a vast army of consumers to a small group of producers catering to the domestic market, raising serious questions of equity. A close examination of the Bangladesh protection scenario is instructive' Just about every consumer good produced domestically is subject to the highest protective customs duty of 25Yo, which is generously topped up with regulatory duty and supplementary duty. Based on the detailed disaggregated tariff data from National Board of Revenue (NBR)' we find that the average nominal rate of protection for these import substitute goods range from 80% to over 200%. Products range from agro-processed goods (e.g. fruit juice, biscuits) to other manufactures (e.g. footwear, ceramics, textiles). The irony is that tariffs on outputs once imposed show no signs of coming down even after decades. Biscuits, for example, are subject to protective tariff of 200%, arguably to prevent import of finer biscuits from Japan or Malaysia. Have we not been making biscuits for centuries? Is this an infant industry? Certainly, the high tariff is not meant for raising revenue because if that were the objective, a total tariff of 25Yo on biscuits would have brought many times more revenue than what is now being received – practically nothing In the process, we are simply giving some biscuit producers windfall profits at the expense of uncomplaining consumers. Finally, I would be remiss not to point out the inherent bias against export production that is created by protection to import substitutes. This fact was rot mooted by the original theorists of

protection. It was something that the dynamic economies of East Asia realized from experience and so had to craft support policies for priority sectors without undermining export incentives because they realized early in the 1970s that export-led growth was the way out of poverty and under-development’ Bangladesh picked up this lesson for its garment industry, thanks to the advice of South Korean investors. Consequently, a l00% export-oriented industry was born with a free-trade channel (duty-free import of inputs and zero-tax on exports) amidst a high tariff and prohibitively restrictive import regime outside this industry. While the going has been good for readymade garments (RMG) as a result of this exclusive arrangement, other exports and potential exports of Bangladesh remain handicapped to this day. A firm that produces goods for exports and domestic sales (e.g. shoes) would, under the current tariff regime, find it more profitable to concentrate on the domestic market (where competition is local and profits higher due to high protective tariff of 128%) rather than embark on a struggle for gaining markets abroad’ To be sure, the challenge for selling in foreign markets is much greater, but foreign markets are vast, and the scope of job creation at home via exports is equally huge. The point of this preceding line of argument is to show the existence of an inherent bias against export production compared to production for domestic sales. According to the latest set of labour force statistics, Bangladesh, the beneficiary of a demographic dividend, will be adding some two million labour to its work force every year. To absorb this work force in well paying jobs will be a major challenge for policymakers. The domestic market, despite its $140 billion size and growing is no match for the $60 trillion size of the global economy which offers opportunities for the creation of several million more jobs in RMG and other emerging export sectors. If we do not wish our demographic dividend to become a demographic liability, going for export markets and export-led growth remains by far the most desirable path of economic salvation for Bangladesh.