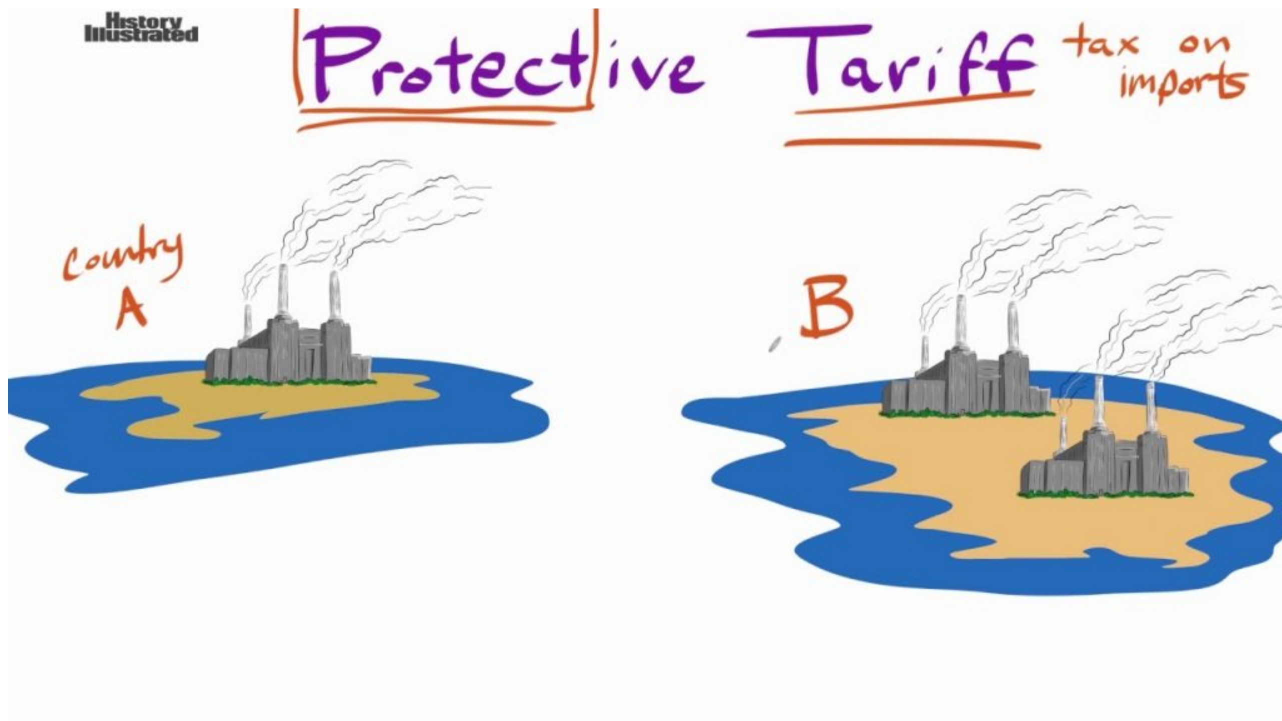

Tariff, protection, and price effects of Budget 2014-15

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The 2014-15 Budget is now an operational document. Taxation and

revenue mobilization, public expenditure, fiscal deficit and its financing, and the import tariff regime visualized in the budget are now having their effect on a wide range of economic activities and economic indicators. Producers and consumers anticipate that prices of many imported products and their domestic substitutes are impacted by the tax measures, particularly import tariffs and para-tariffs. The textbook definition of import tariffs cover custom duties (CD) only while trade literature has identified para-tariffs to describe the various other import taxes and levies such as supplementary duties (SD), regulatory duties (RD), and other surcharges on imports that pop up so often in Bangladesh. Rather than

explore the implications of the overall Budget 2014-15 on domestic prices, the focus of this write up will be on the impact of some notable tariff and para-tariff adjustments on prices of imported products and their domestically produced substitutes.

For the lay reader, let me briefly describe the transmission mechanism from tariffs to prices. While trade theory provides analytical basis for price effects of tariffs, domestic producers are smart enough to know how tariffs protect them from import competition – inaccurately described as 'uneven competition'. For instance, a 25% duty will raise the price of an imported consumer good (e.g. toothpaste) by at least 25% plus mark up and transportation costs. That enables a domestic producer of the same good to raise his price by at least 25% even though he does not pay the import duty. Thus the tariff works as an indirect subsidy, raising his profitability. However, if he has to pay duties on imported raw materials or inputs, his costs are higher and profitability is reduced. So lowering tariffs on inputs has the effect of increasing profitability just as raising tariffs on competing imports. To summarize, higher tariff on an imported consumer product creates the scope for a domestic producer of import substitute to raise his price and increase profitability; lowering of tariffs on inputs also raises profitability by reducing costs. The crux of the problem is whether reduction of input duties alone will push a producer to reduce the price of his finished product. The short answer is 'no', simply because the price of the competing imported product remains untouched so that the protection cover offered by the tariff on his output remains unchanged. Only if the output tariff is reduced along with the input tariff will there be any incentive for reduction of output price. I bring this up because this appears to be a central issue in some of the tariff proposals in Budget 2014-15, as well as in previous budgets.

Here I propose to touch on the implications of two propositions in the budget: (a) reduction of supplementary duties on over 700 products (or, in technical jargon, tariff lines), and (b) reduction of input duties for selected locally produced consumer products and medicines. *Ceteris paribus*, I would like to argue, based on economic principles, that the effect of the first measure will be to lower prices, while the second measure will not. Let me explain.

Supplementary duty is now the major component of para-tariffs that imports are subjected to. SD was introduced in 1991 under The VAT Act as a trade neutral tax, i.e. imposed at an equal rate on imports as well as domestic production, just like VAT. SD actually replaced the

old excise duties and sales tax in a new configuration. Maintaining or enhancing revenue was the principal objective of this tax instrument. Over time, as its name suggests, it has become an additional duty levied on imports. What is disturbing to the analyst is that the original intent of retaining revenue soon gave way to protectionist pressure so that the latter appears to have become the predominant theme of these taxes as the product distribution of SD in Table 1 below shows.

Table 1: Distribution of Top CD and SD by Product Category (FY2015)

	Top CD Rate (25%)		Supplementary Duty		Average NPR (%)
Product Category	#HS8 Codes	Share (%)	#HS8 Codes	Share (%)	
Final Consumer Goods	2140	74.13	1216	82.89	48.0
Intermediate Goods	517	17.91	152	10.36	15.1
Capital Goods	159	5.51	60	4.09	9.7
Basic Raw Materials	71	2.46	39	2.66	13.9
Total	2,887	100	1,467	100	

Source: Operative Tariff Schedule based on NBR ASYCUDA database; PRI staff estimates

Without exception, SD is imposed only on products that are already subject to the highest CD rate of 25%; and 83% of products subject to SD are final consumer goods. It is not a coincidence that most if not all of these consumer products have domestic production. Since one does not hear any complaint from domestic producers about these extra import taxes gives one the impression that domestic producers are pretty comfortable with them. And so they should be because it gives them additional protection cover over and above the top CD rate of 25%. Excluding the high rates on cars, alcoholic beverages, and cigarettes, PRI estimates that the average nominal protection rate (NPR) works out to 48%, against the average of 15% for intermediate goods that are mostly imported. Nominal protection measures the rate by which domestic producers of an import substitute can raise price on account of tariffs on competing imports. The average for all the input categories works out to only 12.9%, creating a deep wedge between output and input tariffs in Bangladesh indicating a very high rate of tariff escalation, an indicator of high protection as well.

The long and short of this story is that the combination of top CD rate and SD restricts imports enough to effectively protect domestic industries from competition. Revenue is lost in the process because when tariffs get too high, they provide high protection but at the

expense of revenue yield. This is probably the case in Bangladesh at least for the tariffs on consumer goods. Which means lowering some of the rates could reduce market prices, stimulate imports and yield higher revenue. Such a measure will benefit consumers at the expense of producers.

That brings us to a discussion of some tariff adjustments signaled in the 2014-15 Budget. The most notable change in direction of course is in the reduction of supplementary duties in about half of the tariff lines subject to SD, i.e. 773 out 1467. The Budget statement makes the case that this was done as a first phase of the realignment of taxes in order to launch in July 2015 The VAT and Supplementary Duty Act, 2012. Be that as it may, the fact that bulk of the reduction was on final consumer goods (667 tariff lines), half of which has domestic production, indicates a moderate change in direction (lowering) as far as protection policy is concerned. In consequence, average NPR on consumer products declined by two percentage points where it was on a rising trend since FY09. Consumers get some relief as this will lower prices. If this is a long-term trend, it would help move the tariff regime in the right direction for the future by also adding a modest doze of import competition. Revenue implications of this move are likely to be favorable as some of the high protective tariffs served as de facto bans on imports.

That brings us to the second notable tariff adjustments proposed. While the general thrust of the comprehensive SD reduction was to reduce protection on a wide range of domestically produced consumer goods, a number of high profile sectors were identified for protection support (raising profitability and protection levels) primarily by scaling down CD on inputs which are basic raw materials and intermediate goods. A list of these preferred sectors for input duty reduction provided in the budget document includes products like Alopethic and Ayurvedic medicines, poultry and livestock industry, paper, ceramics, furniture, plastic, baby diaper, and electrical goods. While the move appears popular, two pertinent issues arise: first, the rationale for selecting these particular sectors and not other equally or more promising sectors remains unclear; second, it is not also clear if the price effects and consumer interests related to these duty adjustments have been properly thought through.

The problem relating to product selection is that any protection policy that relies on non-uniform tariffs is likely to end up preferring one sector over another without any valid rationale. It is practically impossible to figure out the basis for granting discriminatory

effective protection levels to different industries or products. Consequently, these discriminatory tariff adjustments become subject to lobbying by particular quarters making it difficult for policy makers to come to a judicious assignment across all sectors.

As for the price implications of these adjustments, there is the popular notion that, for the products selected, these duty reductions would result in benefits for consumers in terms of lower prices of medicines and other popular consumer items produced domestically. This expectation is unrealistic. The economic principle (explained earlier) underlying the price effect of these adjustments is simple: for consumers to get relief in terms of price reduction of these selected products, tariffs on output would have to be reduced as well. If they are not, then the reduction of duties on raw materials will simply raise profitability of the firms producing these preferred products simply as a result of these tariff adjustments rather than any improvement in efficiency or productivity. A somewhat different situation exists for the medicine manufacturers. Since a *de facto* ban exists on import of drugs and domestic pharmaceutical companies meet some 97% of all of domestic demand, there is a tacit policy of controlling retail price of locally produced drugs. In that case, it rests with the DG Drug Administration to reduce the cap on the price of selected medicines in order to give consumers some relief against the reduction of raw material duties.

To conclude, bucking past trends, fiscal 2014-15 Budget provides mixed signals in terms of the price implications of proposed tariff adjustments, giving some relief to consumers via modest downward adjustment of supplementary duties on consumer goods. However, the downward adjustment of duties on raw materials of selected products and medicines is likely to raise profitability of firms without any incentive for lowering prices for the benefit of consumers. One wonders if this was really the intent of the tariff adjustments.

The good news is that after many years of rising nominal protection the change in approach is welcome and a move in the right direction, something that will infuse a modest doze of competition while offering some price relief to consumers who have traditionally borne the brunt of the protection tax.

It is high time for Budgets to pay attention to consumer interests and not simply focus on demands of producer groups with strong lobbying capacity who will always seek higher tariffs on outputs and lower tariffs on inputs. High protection in perpetuity neither improves

productivity nor ensures competitiveness in the long-term. New protection needs to be made time bound while prevailing high protection needs to be scaled back in phases.