The great resource transfer no one talks about

Sunday, Jul 5, 2009

By *Dr. Zaidi Sattar*

The late Professor Mancur Olson taught economics at the University of Maryland until his death in 1998. He wrote his Ph.D thesis at Harvard University on a subject that barely skirts economics. It was on the subject of collective action by citizen groups. His first book, The Logic of Collective Action, based on his thesis, was published in 1965, and became an instant hit in academic circles in US and Europe. He was regarded as one of the most distinguished economists of his generation, who spurned many offers from Ivy League campuses. The central argument of his book was that when groups are large, or dispersed (e.g. consumers), they have difficulty organizing to lobby for a policy action that would benefit the group as a whole. On the other hand, smaller groups (e.g. producers), who might be locationally concentrated, can much easily organize for collective action. Consequently, it is the smaller groups that are likely to have stronger lobbies to influence their way towards extracting gains from policy actions.

For an observer of the Bangladesh scene, it should not be difficult to visualize how the Olson hypothesis is playing out – almost as he predicted. Producers of goods and services, for domestic consumption or export, are organized within chambers of business and industry, or in associations of their own product group – e.g. steel, ceramics, textiles, garments, agro-processed food, leather, footwear, and beverages. There are also chambers of commerce and industry in each district town, besides an apex chamber at the national level.

When it comes to the price of products, the interests of producers and consumers diverge. The former would like to obtain the highest price for their products in the marketplace while the latter group would want to keep prices down. Now, in Bangladesh, we import goods whose total value in FY09 was US$21 billion, or 24% of GDP. Those imports were subject to an average of 20% protective tariffs (will be about 23% next year). These tariffs on imports generate revenue for the national exchequer, but also raise the price of imported products, thus raising the profitability of domestic producers whose products compete with imports. It is not surprising then to see producer groups actively pursuing policy makers to perpetuate and even enhance the level of protection. That is where the catch lies.

Table 1 shows that there are four broad categories of imported products of which the first three are imported by producers for use in the production process. Roughly, 80% of our imports fall in this group, and, surprisingly, the proportion has not varied much over the years. Lower tariffs on these products reduce costs of production. Producers have lobbied hard to get tariffs on inputs lowered, with a good measure of success. As for the imports described as final consumer goods, interests of consumers and producers clash. Tariffs on these imports have been rising, to the benefit of producers, at the expense of consumers.

Table 1: Import categories and their top tariffs

Import Category	Share (%) in FY09	Top tariff rates
1. Basic Raw Materials	13.65%	5.0
2. Intermediate Inputs	38.83%	12.0
3.Capital Goods/machineries	26.12%	3.0
4. Final Consumer Goods	21.41%	56.0*
Sub total (1 to 4)	100.00%	

(*) Excluded are higher rates on cigarettes, alcoholic beverages, motor cars. Domestic manufacturing industry is largely concentrated in this product group, with a small but growing intermediate goods sector. A slew of consumer products compete with imports ranging from soap, toiletries, paper products, ballpoint pens, ceramic tiles, beverages, mineral water, chocolates and biscuits. Protective tariffs on these products under the latest budget range from 56% for ballpoint pens and paper products to 156% for chocolates and biscuits. These numbers only measure nominal protection. Because tariffs on their imported inputs are much lower, effective protection, which reflects profitability by taking into account the spread between input and output tariffs, would be much higher.

Importers and producers know how the tariff works on the price of a product. The following illustration is for the lay reader. For example, if the landed cost of an imported toothbrush is

Taka 100/-, given the current import taxes (customs duty or CD=25%, supplementary duty or SD=45%, regulatory duty or RD=5.0%, etc.), this toothbrush will be priced at over Taka 200/-. A locally produced competing toothbrush which would have sold for Tk. 75/- (if there were no duty on imported toothbrush) can now be priced at, say, Tk. 150/- or more (assuming it is not of the same quality). Thus, for every local toothbrush sold, there is a transfer of Tk. 75/- or more from the consumer to the producer – purely on account of the tariff. As for the imported toothbrush, the tariff revenue goes into the national exchequer. To the extent the tariff displaces competing imports, it protects the local producer and results in a transfer from the consumer to the producer.

Tariffs protect by raising the price of imported consumer goods and allowing the local producer of import substitutes to raise their prices as well. Because of this, protection is a tax on the consumer and an indirect subsidy to the producer. And the tax burden on the consumer is directly proportional to the level of protection. The arguments in favour of industrial protection are well known: promotes local industry, creates jobs, improves balance of payments, etc. Those arguments may be countered by the lack of competitiveness and potential for inefficiency and associated costs or waste of resources. What is worse, history is replete with so-called “infant industries” that require perpetual life support. Readers might be surprised to learn that our chocolate and biscuit producers, having been in business for over 50 years, just got a gift of 175% protection from the new budget! In my opinion, the only sensible and valid argument for protection would be for “time bound” support to a nascent activity.

Until the early 1990s, the country pursued a policy of import substituting industrialization by imposing bans and quantitative controls on imports alongside high and prohibitive tariffs. Bangladesh consumers bore the brunt of the heavy cost in terms of high prices (above world prices) of consumer goods and limiting choice of products. Local producers reaped the benefit of that policy. It remains to be seen how many of those protected industries have become internationally competitive and can now survive without tariff protection.

It is a mistaken belief that the readymade garment industry (RMG) is a protected industry. It is not. It receives no protection on the price of its finished products in the retail markets of US and Europe. It therefore requires world-priced inputs and deserves the duty-free import of fabrics and other inputs in order to be internationally competitive. Indeed, all exports require and deserve such facility.

Suffice it to say that protection makes local industries currently more profitable than they would be without it. But it also makes them inefficient, and internationally uncompetitive in the long run. That is the reason why India has opened up its market after 50 years of keeping it virtually closed to international competition, after realizing, at the end of those years, that Indian goods were not of international quality. Exports from India jumped from 3.0 per cent of GDP in 1980s to 15 per cent of GDP in 2008. Because of the large size of the Indian economy, Indian producers in general face much stiffer competition than Bangladeshi counterparts.

There is not enough space in this column to discuss the pros and cons of protection. That is left for another occasion. The subject here is the matter of resource transfer from consumers to producers via the instrument of tariff protection. As long as there is protection to local industries, this transfer will persist. The question policy makers face is how long can this resource transfer be justified. If protection is time bound, consumers would know that the tax is for a just cause; to see a local industry grow and become competitive, after a certain period of time.

That consumers are the payers of the indirect tax of tariff protection is seldom raised in the current discourse. Like Professor Olson had predicted, consumers are too dispersed to organize to protect their own turf – the right to choose what products to consume, at internationally competitive prices. Consequently, the unrequited transfer of resources from the unorganized and dispersed consumers to the more organized producer groups continues unabated. And annual budgets, one after another, continue to offer the seal of approval to this iniquitous process. (Dr. Sattar, a trade economist, is Chairman, Policy Research Institute of Bangladesh. Research support was provided by PRI's Ziaul Ahsan. The writer may be reached at e-mail:zaidisattar@gmail.com)