

The truncated new VAT law and exports

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By *Dr. Zaidi Sattar*

So the waiting and uncertainty is over. The new Value Added Tax (VAT) Law now goes into effect. For all domestic economic activities (with some exemption), there is a uniform VAT rate of 15 per cent. Truncated application of VAT is history, finally.

As the title suggests, there are two parts to this Law: (a) the part that deals with application of VAT at 15 per cent on all economic, and (b) the part that deals with the imposition of Supplementary Duties (SD), by and large, for the protection of domestic industries. But, as an analyst, I find that the Law itself has been truncated in its application. How? The part of the Law that deals with “Protection of domestic industries” has been defused. It will not be implemented. The drastic removal of SD, as proposed in the new Law, will not take place. Instead, 142 more tariff lines have been subjected to SD that covered 1532 tariff lines in the old system.

The research by Policy Research Institute (PRI) has shown that 95 per cent of SD was applied on imports only, and so was essentially a “protection” tax. Its application will continue to remain the same in the new Law. While the drastic reduction in protection as proposed in the new law was impractical, it is now clear that the government has chosen to leave protection where it is, perhaps slightly scale it up. Thus a great opportunity was missed to move the economy to a “moderate” level of protection. Perhaps the government sought to avoid a “double whammy” - full blown VAT on businesses and loss of protection to industry at the same time.

Let me add a bit of perspective. Under the multilateral rules-based trading system, the world has moved past the first generation of trade reforms where tariffs and import quotas were used extensively for protection. For developing countries, the next agenda of trade reforms

has to deal with trade facilitation including what is called “behind-the-border” issues. Tariffs across the world have come down albeit there are sticky issues of developed countries still levelling high tariffs on major products imported from developing countries (e.g. apparels and footwear), though most developed countries offer duty-free quota-free (DFQF) option for the least developed countries (LDCs).

In the world tariff tables prepared by World Bank, Bangladesh looks good with average custom duties (CD) reduced from about 80 per cent in 1992 down to only 13 per cent today. Para-tariffs like SD are not within the purview of these comparisons as international agencies find it impossible to make sense of ad hoc levies on imports made by many developing countries. Hence, Bangladesh gets good marks in periodic World Trade Organisation (WTO) Trade Policy Reviews in Geneva though the issue of non-transparent levies does come up in discussions but are left in sidelines. As an LDC, Bangladesh can get by with such infractions, but once it graduates out of LDC status (in another six years), these infractions could become thorny trade policy issues under the rubric of WTO. Therefore, in order to play our part in the rules-based global trading system of the future, we need to prepare now for an eventual phase out of non-transparent import levies.

However, the immediate point of this post-budget analysis is not how the external world sees us but how it affects incentives between exports and import substitute production in the domestic market. We have moved on to a higher gross domestic product (GDP) growth trajectory of 7.0 per cent+ arguably on the back of superior export performance in the past 25 years. Our seventh Five Year Plan target is to achieve 8.0 per cent GDP growth by 2020. The fact is that no country has achieved 8.0 per cent (or higher) growth without superb export performance – not China, not S. Korea.

So where does the truncated VAT Law leave economic policy for dynamic export growth at a time when our exports face headwinds of sluggish global demand growth? For one, it leaves tariffs, para-tariffs, and high protection where it was. While we all agree that we need to nurture our nascent industries for some time before they can become competitive, the policy of high protection ad infinitum is not helpful in achieving international competitiveness or creating the millions of jobs needed to lift our people out of poverty.

The focus on export-oriented manufacturing growth has further brought the protection issue

to the forefront. Because high protection for import substitutes and export expansion and diversification are two goals that are not only mutually exclusive but also in sharp conflict with each other because protection raises relative profitability of sales in the domestic market over that of exports.

So we can't say in one breath that we want exports to flourish and be diversified while at the same time doggedly clinging to a regime of high protection. Something has got to give. An opportunity for rationalisation of the protection structure — long overdue — was missed.