To protect or to export

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Yes. This is the policy dilemma though largely unknown if not ignored. For the Bangladesh economy the 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. This is the policy choice we face for the burgeoning import substituting manufacturing sector that also produces for exports (non-RMG). It would have been appropriate for the FY2016 budget to recognise this as a policy dilemma and take some steps towards resolving it in order to give exports a policy boost.

Our preliminary assessment of tariff adjustments (Table 1) in the budget for the financial year (FY)2016 reveals no fundamental change in the approach to tariff protection, except for a minor reduction in the top rate of 30% (CD=25%, RD=5%). It has been proposed in the budget to reduce the RD by 1% to set at 4%. With increase and decrease of rates nearly balancing each other out, in the overall scheme of nominal

protection, that yields the result of a modest reduction of average nominal protection rate (NPR) by about 0.9 percentage point (Table 2), as the preliminary Policy Research Institute (PRI) tabulations show from the

various NBR documents detailing the adjustments in customs duty (CD), regulatory duty (RD), and supplementary duty (SD) proposed in the FY2016 budget. The modest reduction in

average NPR, from 26.7% in FY2015 to 25.8% in FY2016, is largely the outcome of reduction in the RD rate from the long held rate of 5% to 4%, resulting in the lowering of protection to consumer goods by about 1.5%. Some 200 tariff lines with protective SD of 60% faced a reduction to 45%; at the same time we find that 369 tariff lines with 15% SD saw an increase in protective duty to 20%. The net result of this as shown in Table 3 is that the overall protective effect from SD moved little (from 9.5% to 9.1%). A huge challenge therefore remains in eliminating SD as a protective tax by either making them trade neutral (equivalent SD on import and domestic production) or just removing SD from some tariff lines. This is supposed to be done when the VAT (value added tax) and SD Act 2012 goes into full effect next July, as per announcement of the finance minister. That would mean eliminating nearly one-third of the average protection now available to import substituting industries at one stroke. Does it sound practical? In a previous write up on Supplementary Duties, Protection, and Revenue, I had argued for a phased implementation of the new Law and hoped that the first steps would have been taken this year.

The policy dilemma emerges because of the need to fuel an export boom in order to scale the heights of 7%+ 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 7th Five Year Plan (FY2016-2020) expects manufacturing growth to average 11%+ over the next five years. Is this possible while maintaining high protection levels to domestic import substituting industries?

Protecting domestic industries against import competition has been a popular strategy for industrialisation practiced by almost all economies in their early stage of development. On the other side of the coin, many economies have realised the benefits of export-led growth, particularly after the impressive growth performance of East Asian economies during the 1970s and 1980s. The two policies are inter-related such that one policy might adversely affect the other. Import taxes on imported inputs hurt competitiveness of exports, and may also undermine protection to domestic industries. More relevant for the Bangladesh context, tariff protection, which raises profitability of import substitute production, creates an inherent anti-export bias. 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.

Bangladesh presents a textbook case of how high protection can discourage exports. One result can be seen in the lack of progress in export diversification. The dualistic trade policy of “free trade channel” for RMG exports and a dysfunctional duty drawback system for other exports persists, resulting in poor performance of non-RMG exports. Compounding this problem is the high profitability (propped up by protective tariffs) of sales in the domestic market compared to exports. Typically exports fetch profit margins of 5-10%, compared to profit margins of 15-20% in domestic sales. If firms that export and also produce for the domestic market (i.e. firms that are not 100% export-oriented) find domestic sales to be far more profitable they will naturally be lukewarm toward export production. And this is not helpful to the goal of robust export performance. That presents a dilemma for the policymakers. If exports are to be promoted, restoring a balance between export profitability and returns from domestic sales leaves two options: providing duty-free inputs to all exporters through bonded warehousing scheme on the one hand, and scaling down protective tariffs on the other. The bias against exports will persist unless protective tariffs like SD are scaled down or made trade neutral.

Rather than turning the incentives around to fuel an export boom, the budget proposal to raise withholding tax on all exports to 1% seems like an oxymoron in the current context. It is understandable that this action is a revenue imperative, arising from the inability to mobilise revenue from taxing income of exporters, some of whom (e.g. RMG exporters) are known to have high taxable income. Although this is not supposed to be an export tax, but an income tax withholding that is supposed to be a final settlement, it assumes all the trappings of an export tax.

In a mercantilist world (that believes in increasing exports and restricting imports), an export tax is a rare event practiced by some low income countries to raise revenue but it is usually imposed on agricultural and food commodities. Recently, export taxes were imposed by Indonesia on palm oil, by Madagascar on vanilla, coffee, pepper and cloves, by Pakistan and India on raw cotton, by the Philippines on copra and coconut oil, and by the European Union on wheat — all examples of the use of export tax on agricultural products. 95% of Bangladesh exports are manufactured goods. Example of an export tax on manufactures is

difficult to find. Although World Trade Organisation (WTO) rules do not prohibit export taxes, over two-thirds of its members have chosen not to apply them, recognising that they distort trade and may lead to welfare losses. Only three OECD countries use export taxes, and many regional and bilateral trade agreements explicitly prohibit them. So should Bangladesh, sooner rather than later, in the interest of maintaining the maximum incentives for exports.

Then there is the consumer – the largest stakeholder in the economic policy space. The consumer bears the ultimate burden of the protection tax. It seems unfair that consumer groups are pretty much left out of the pre-budget consultation process, perhaps for lack of their strength in organising for what the late Professor Mancur Olson (The Logic of Collective Action, 1965) called “collective action”, i.e. forming associations for lobbying. In this case, the interest of exporters and consumers converge. Lower protection reduces prices of consumer goods in the domestic market making export activity relatively more attractive.