Towards rationalising the tariff structure

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The efficiency with which import taxes are collected has a direct bearing on overall revenue mobilisation and trade facilitation; the latter objective figuring more prominently in the policy space as the economy becomes more integrated with the world economy through trade. How efficiently and effectively the National Board of Revenue (NBR) collects import taxes affects incentives in business and investment, and, in consequence, on overall economic performance. A good time to address the multifarious challenges in revenue mobilisation is during annual budget formulation.

Though a strategic shift from import to domestic-based revenue sources is taking place, the government's continued heavy reliance on import-based taxes for revenue collection poses quite a few challenges (Table 1 in page 3).

First, the challenge is to reduce the share of import-based taxes without loss in overall revenue which has to grow faster than nominal gross domestic product (GDP) in order for Bangladesh to come out of the quagmire of "low tax-GDP ratio".

Next, the existing structure and distribution of customs tariffs present a number of anomalies that create problems for customs administration, on the one hand, and distort business and production incentives, on the other.

Simplicity and transparency — two critical yardsticks for judging the efficiency of tariff administration — are often sacrificed in the interest of raising revenue or providing protection to domestic activities. Collection of customs revenue in the most efficient and transparent manner remains a major challenge in the context of budget formulation in recent times.

To the extent that the NBR can bring dynamism in its domestic taxation efforts (namely, through individual and corporate income tax and value added tax or VAT, collection), its reliance on customs revenue and import-based taxes could be that much scaled back.

In this brief analysis, an attempt has been made to summarise some of the key challenges in rationalising the current tariff structure which, by all accounts, remains complex largely owing to the pursuit of too many objectives all at once.

Before addressing the issue of tariff rationalisation, it is critical to review tariff trends in the recent past (Table 2). Between fiscal year (FY) 01 and FY13, one sees a reduction of average Total Tariff Incidence (TTI) and Nominal Protection Rate (NPR) up to FY10, then rising by FY13. Much of the reduction over the period between FY01 and FY10 was due to scaling down of CD (customs duty) and SD (supplementary duty). But rise in TTI/NPR by FY13 was largely due to again raising the SD slabs. Top NPR rates applied mainly on leading import-substituting industries have been rising over FY01-FY13. Most recently, between FY13 and FY16, we saw a reduction of all the three indicators. This trend needs to continue over the period of the 7th Five Year Plan (FYP).

Nominal Protection Rate (NBR), is a protection indicator.

RATIONALISING SUPPLEMENTARY DUTIES: In the previous economic analysis on budget challenges that was published in The Financial Express in its issue on April 24 last, this writer argued for the rationalisation of the protection regime. The way the current tariff structure is laid out, a big portion of the protection comes from supplementary duties applied to tariff lines representing final consumer goods which comprise the bulk of production of import substitutes in the domestic market. At present the products with the highest rate of NPR include biscuits, toiletries, furniture, footwear, glassware, ceramics, fans, and electric lamps.

Surprisingly, even readymade garment (RMG) which needs no protection is subject to the highest rate of NPR. The next highest NPR rate is 72%, given to fabrics and such domestically produced items as sanitary wares. So essentially any product (mostly final consumer goods) that is produced domestically has been given the highest NPR treatment, with the result that domestic consumers are essentially paying prices around 70-100% above world prices for these products, imported or produced locally.

One of the ways to reform and rationalise the tariff regime would be to scale back SDs or at least apply them on a trade neutral basis, as the new VAT and Supplementary Duty Act (VSDA) of 2012 requires. It is amply clear to any observer of the Bangladesh industrial scene that removing all SDs or making them all trade neutral is impractical.

The arithmetic is mind boggling, as the research findings of Policy Research Institute (PRI) show that application of VSDA will in one stroke reduce average NPR from 25.6% to 16.7%, and top NPR would come down sharply from 87% to 46%. As Table 2 shows, reduction of protection has been at modest rates of 1.0-2.0% a year. Though it is time for some serious rationalisation of protection structure, policymakers have to strike a balance between what is needed and what is feasible. Doing nothing is not an option either.

Thus, the political economy of reducing protection levels by converting all SDs trade neutral in one stroke appears too constraining because it will raise strong opposition from the import-substituting enterprises. Nor is such a move recommended because of its disruptive impact on the manufacturing sector. Only a phased withdrawal of SDs, implying a phased reduction of effective protection over time, is a feasible option.

To smooth the transition from a high protection to a moderate protection regime (let us say, during the 7th Plan), the following specific adjustments may be made, with announcement of future downward reduction of protective SDs. First, all the high SDs on automobile imports can be made trade neutral, while giving special exemption to domestic automobile assembly plants (e.g. Progoti, Proton, etc.).

Next, a nominal CD of 5.0% could replace the 87% NPR on RMG and 49% NPR on jute textiles simply because RMG needs no protection, and jute textiles are not imported.

Finally, to rationalise actual protection levels, SD of 45% could be scaled back to 30% or lower, on import substitutes that are subject to the top CD rate of 25%. That would reduce top NPR from 87% to 77%.

Trade economists will argue that more reduction is efficient but that might not be politically feasible. Even then, the modest tariff adjustments proposed here will result in a reduction of average NPR to 21%, from the current level of 25.6% — a significant reduction of NPR by historical standards. If there is an understanding that protection deserves to be rationalised, some announcement about time-bound protection in future would make both political and economic sense.

To be fair, there has been a lot of progress in rationalization of the tariff structure in Bangladesh, since the early 1990s, such as (a) reducing the number of tariff slabs from 23 in fiscal year (FY) 92 to five in FY15, (b) moving towards uniformity in tariffs by reducing multiplicity of rates within each HS4 heading (which cover harmonized system or HS, codes of similar products), (c) removing tariff anomalies where input tariffs exceeded output tariffs in specific sectors, (d) reducing prohibitively high rates of customer duty (CD) which hurt exports and domestic production alike.

In essence, there has been progress in bringing some order out of chaos in the structure of tariffs. But the task remains incomplete and there has been more than an occasional tendency for slippage from the reform path.

One glaring anomaly is the rate of tariff escalation in our tariff structure. Tariff escalation is described as imposing higher rates for higher stage of processing. While input rates are bunched together (Table 3) in a range of 1.0-10%, output rates (on finished consumer goods) start at 25% with generous supplements of regulatory duty (RD) and supplementary duty (SD), resulting in a top nominal protection rate (NPR) of 87%.

In the case of top NPR rates, the top customer duty (CD) rate of 25% is illusory, as all can see. In a comparison of comparator countries and regions (Table 4), we find Bangladesh to have the highest rate of tariff escalation, indicated by the tariff escalation ratio (TER).

What is not known is how and when the decision was made to formulate such a high rate of escalation between input and output tariffs. It can only be surmised that the pressure for protection from import substituting industries has led to such an extreme outcome!

In a comparison of tariff escalation indicator (i.e. TER), the research studies by Policy Research Institute (PRI) found no developing country or region with such high escalation ratio. India, which caps all manufacturing tariffs at 10% (with few exception) has TER of only 1.51, with input and output tariffs closely bunched together. That is because India has a wide base of intermediate goods production, something Bangladesh does not have. That brings us to the next issue of tariff rationalization.

RATIONALIZING CONSUMER AND INTERMEDIATE GOODS TARIFFS: Whereas trade in intermediate goods is the fastest growing component of international trade, all protection incentives in the country seem to be focused on finished consumer goods leading to an anti-intermediate goods bias, thus impeding the growth of backward linkages in the economy. Share of intermediate goods in our export basket is barely 2.0%.

A rebalancing issue revolves around the support for domestic production of intermediate goods. For instance, chemical and steel industries, and machinery parts (light engineering sector) are strong candidates for expansion in a rapidly industrializing economy. Intermediate goods industry represents backward linkage for the entire economy including all the sub-sectors: agriculture, manufacturing, and services.

Bangladesh has a small but growing intermediate goods industry which up until now has had little support from the tariff structure. They also fall within the small and medium enterprise (SME) sector which has now been identified for promotion through greater access to credit facilities. Over the years, tariff on intermediate goods have been rationalized (assigned general rate of 10%) and reduced. This class of imports has the highest share in total imports and also yields the highest share of customs revenue.

It would be tough to argue that, in a rebalancing scheme that throws some weight on supporting intermediate goods industry, the rate of 10% should be moved up a notch. Yet, time bound protection of certain intermediate products could be selectively given protective rates equivalent to the top rate for consumer goods.

In the interim, there are two options for tariff on intermediate goods: (a) to leave them at the current rate of 10%, i.e. not reducing this any further; and (b) to reduce them gradually and only in tandem with reduction of the top rate of 25%, as and when that happens.

What becomes clear from the preceding analysis is that rationalization of tariffs is an essential component of rationalization of the protection regime. In an earlier economic analysis as mentioned before, this writer had made the case that high protection contains an inherent anti-export bias, particularly for non-RMG exports that are not exposed to the free trade regime given to RMG. It is safe to argue that the currently high protective tariff structure also yields sub-optimal revenue from customs, as some of the high tariffs (e.g. on biscuits) act as de facto ban on imports.

Given the comfortable level of foreign exchange reserves, there is an opportunity to launch a phase of gradual tariff liberalization that can begin with consumer goods subject to the top NPR rate. It leaves little to the imagination that scaling down some of these rates would actually yield higher revenues with modestly higher import penetration without a dent in our balance of payments. If anything, it could take some appreciation pressure off from the exchange rate while giving Bangladesh Bank some breathing space in monetary management.

In concluding, one cannot but say emphatically enough that if the goal of NBR is to rationalize the tariff structure, it must approach the entire tariff structure holistically and embrace certain cardinal principles of simplicity and transparency, such as having a uniform rate within each HS 4-digit heading, because under each heading the codes represent similar products or minimal change in processing. Deviation from these principles should be made only in exceptional circumstances when the case for revenue, protection or national interest is strong and convincing. Adhering to such principles can eliminate the pressure of lobbying by interest groups to eke out tariff benefits to serve narrow private ends.