



Trade policy for the 21st century

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Over the past two decades, Bangladesh converted its trade policy

☒ regime from a near-autarkic one during the 1970s and 1980s to a progressively more open regime. The policy reforms have been focused and comprehensive involving a dismantling of most quantitative trade restrictions and sharp reductions in custom duties. This has served Bangladesh well. Merchandise trade (exports plus imports) to GDP ratio has expanded from 21 percent in FY1992 to 52 percent in FY2012. Exports have grown from a

mere \$2.6 billion in FY1992 to \$24.3 billion in FY2012, attaining a heady pace of growth of 12 percent per year. The readymade garment sector, which has been the leader in the exports boom, alone has created 3.6 million jobs, accounting for almost 60 percent of total manufacturing employment. Overall, the expansion of exports has contributed substantially to GDP growth, employment and poverty reduction.

The supportive role of trade policy in promoting exports can be seen not only from a simple correlation between the removal of trade barriers and growth of exports but much more convincingly from the experience of the garment sector. There is a misperception that apparel exports boomed owing to the multifibre agreement (MFA) of 1974 that allowed foreign investors to take advantage of the quota space allocated to Bangladesh. While the MFA indeed created the initial space, subsequent growth in garment was facilitated by a number of important factors of which the bonded warehouse system that allowed duty-free imports of raw materials played a critical role. By allowing access to world prices for both inputs and outputs, the trade policy provided a huge impetus to garment exports. At the same time, by dismantling many of the instruments of trade protection to inefficient domestic production trade policy helped lower the disincentive for exports.

There was a fear that the phasing away of the MFA in 2005 will hurt garment exports. Events have proven the prophets of doom wrong. Contrary to their predictions, the Bangladeshi garments gained additional market share after the MFA phase-out owing to the inherent accumulated strength of the sector based on productivity and cost advantages. Indeed, with cost escalation in China and India owing to growing labour cost, the prospect for Bangladesh in gaining additional market share of global garment is bright. To take advantage of this prospect Bangladesh will need to take swift and firm actions to remove some of the emerging constraints, especially the globally explosive issue of worker safety at the workplace.

One important question is if trade policy supported the growth of garments, why is this positive experience not seen in the case of other exports? There are two major reasons for this. First, the full benefits of the trade policy liberalisation and its implementation through the bonded warehouse system are not available to most other exports. It is true that custom duties and other import levies are generally low for capital machineries and raw materials and there is also a duty draw-back system, but actual implementation leaves a substantial gap in terms of time and transaction costs (unlike the benefits of a bonded warehouse

system). Additionally, the back-to-back LC system for garment inputs and outputs is also not available to most other exports.

A second very important factor is that trade policy is only one element of support for exports. Other determinants include labour skills, technology, foreign investment and skilled entrepreneurs. A critical factor for the success of garment is the ability of this sector to attract a large number of skilled and talented entrepreneurs who in turn have invested significantly on in-house training of the labour force. Indeed the cost advantage of the apparel sector emerges from the fact that it has very successfully tapped the hugely abundant and low-cost women labour force into an asset by providing them in-house all the training needed for production. This innovative in-house labour training is not a universal phenomenon in Bangladesh. The role of foreign direct investment is another positive feature that has contributed to the growth of the apparel sector by transferring technology and know-how from the international marketplace.

Notwithstanding its positive contribution to development, trade policy has come under stress in the past few years. The main pressure has come from the fiscal side. Inadequacy of tax revenues, mainly from income and wealth sources, has caused the government to go back on some of the tariff reductions with the introduction of supplementary duties or para tariffs. This reversal of trade policy reforms is mostly unintentional. The primary motive is revenue collection rather than trade protection based on strategic considerations. Nevertheless, the signal to investors is worrisome. The complex system of supplementary duties has resulted in an arbitrary regime of trade protection that imparts a substantial anti-export bias.

Between FY1992 and FY2009 the average custom duty has come down sharply from 71 percent to 15 percent (it was 100 percent in 1985). This has also lowered the average nominal rate of protection (NPR), down from 74 percent in FY1992 to 20 percent in FY2009. However, the NPR has started rising since then, reaching 27 percent in FY2012, due to the growing influence of para-tariffs, such as supplementary and regulatory duties. Indeed, the para tariffs now account for 48 percent of the NPR, as compared with only 3 percent in FY1992, suggesting that they have become a huge countervailing force to the reform of custom duties. There is also a growing wedge between output and input tariffs resulting in higher effective protection (ERP) for domestic producers at a cost to exporters who face anti-export bias in export expansion and diversification.

Bangladesh still imposes high protective tariffs, especially on consumer goods, by international standards. A study of ERP done by the Policy Research Institute for 100 firms across 11 manufacturing sub-sectors in 2012 reveals that effective protection rates far exceed NPRs by wide margins because average input tariffs are well below output NPRs. Barring intermediate goods, most consumer goods production in Bangladesh have output NPR rates between 50 percent and 100 percent (200 percent for biscuits!). Thus, the ERPs for domestic sales work out in the following ranges: agro-processing (100 percent for fruit juices to 600 percent for bread and biscuits); footwear (214 percent-342 percent); leather products (244 percent for bags); bicycles (117 percent-215 percent); ceramics (190 percent-215 percent); electronic products (272 percent for solar bulbs); plastic products (87 percent- 483 percent).

This illustrative pattern of effective trade protection is not necessarily based on any rationale or strategic considerations to influence resource allocation or create employment opportunities. I am not aware of any empirical evidence that shows that this system of trade protection and the associated trade policy has contributed to rapid growth of the manufacturing sector or created jobs in the protected sectors. On the contrary, as noted earlier, most manufacturing jobs in the past 25 years or so (3.6 million) have been created in the garment sector that receives zero trade protection. A priori, it could also be argued that the resulting system of incentives indicated by the ERPs imposes a huge negative bias against exports. It is therefore imperative for the government to ask why the present system of trade protection should be preserved. The economic rationale of the current trade system needs to be urgently analysed, reviewed and reformed to support export diversification and growth of the manufacturing sector.

Based on economic theory and history of economic development, one might argue for selective trade protection on strategic grounds of dynamic comparative advantage. This requires solid analytical research to provide the rationale for such protection and a time-bound system of protection that is reviewed and revised based on outcomes. The government lacks the institutional capacity to do this and would need to acquire this capability by partnering with local research institutions.

Presently, trade policy reforms have stalled and largely overtaken by revenue considerations. This is not a good policy outcome. Trade policy must be guided by the needs of export

promotion and efficient import substitution. Revenues are best generated through income and value-added taxes. The ongoing reforms of the VAT are a welcome development. There is now an urgent need to reform the income tax through administrative simplifications, rates and exemption rationalisation, bringing capital gains in the tax net, and introducing a modern system of property taxation. The earlier this reform starts, the easier it would be to rationalise the system of trade taxation to support the growth of manufacturing sector value-added, exports and jobs.