Whither trade neutrality of supplementary duties?

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When it comes to trade policy, one can say that Bangladesh changed gear in the early 1990s, turning from an inward-looking import substituting policy towards an outward-looking export-oriented policy. This shift was accompanied with a radical move towards trade openness that saw import bans and restrictions phased out, tariffs reduced and rationalized, the current account made convertible, and the exchange rate moved from a fixed to a flexible regime.

Crude estimates suggest that a third of the tariff lines in 1990 were subject to tariffs of 100%

and above which constituted an effective ban on these imports in addition to the wide range of quantitative restrictions or bans that prevailed. What was ostensibly believed to be measures to save foreign exchange and shore up the balance of payments (BOP) actually did nothing to prevent a BOP crisis in 1990. That crisis and the emergence of political democracy turned the tide. What is clear today is that trade policy measures launched in those days paid huge dividends in terms of growth, employment, and income.

Trade liberalisation involved drastic cuts in tariffs. Apprehensive of losing a lot of revenue, the National Board of Revenue (NBR) tried its best to retain some revenue sources under the liberalized regime. Supplementary Duties (SD), introduced under the Value Added Tax (VAT) and Supplementary Duties Act of 1991 and applied on a host of so-called "luxury goods", was one of those measures to prevent revenue losses. Like the VAT, SD was to be a 'trade neutral' tax, i.e., applied equally on imports and substitute domestic production.

The VAT rate that was fixed at 15% was applied equally on all imports of Vatable products, excluding those that were exempt such as primary agricultural products and lifesaving drugs. Even in this case, the textile sector was exempted from VAT on domestic production with the result that VAT on imported textiles worked as a purely protective duty.

Trade neutrality is ensured by bringing about price equality between the imported product and domestically produced import substitute, assuming, for the sake of argument, that the two products are perfect substitutes. For instance, an imported toothpaste costing Tk. 100/- with a customs duty of 25% will be priced in the domestic market at Tk. 125 plus mark up and transportation cost. A similar domestic toothpaste has the option of pricing it at anywhere below Tk. 125 if there is no equivalent tax on domestic production. A SD of 20% will raise the import price to Tk.150++. A higher import price gives the domestic import substitute the scope to raise its price. A trade neutral SD – one that taxes import and domestic substitute equally — ensures that the domestic toothpaste will be priced close to the competing import. That is not happening with the current SD regime.

Much like the VAT on imports, SD was originally applied as a trade neutral tax. But, as pressures for protection mounted, in course of time, the trade neutral aspect of SD appears to have been abandoned by reducing or eliminating the domestic part of the tax, while leaving the import component in tact. In consequence, for all practical purposes, SD, by and

large, became a protective tax.

A careful analysis of the products subject to SD will tell the story. Of the 1461 tariff lines (traded products) subject to SD, ranging from 10% to 500%, only 153 tariff lines (about 4%) include high taxed items such as automobiles, cigarettes, and alcoholic beverages. The remaining 1300 lines cover pretty much all of the consumer goods that are domestically produced and are already subject to the highest customs duty (CD) rate of 25% with an additional regulatory duty (RD) of 5%.

Table 1 illustrates the protective outcome of SD in the overall tariff scheme. Though the average tariff incidence (all import taxes) is 50.6%, the average nominal protection rate (NPR, which measures the protective effect of tariffs and para-tariffs) is 26.7%, of which 9.5% or 36% comes from SD. What is notable from columns 2 and 3 is that for all but a few of the tariff lines, SD has predominantly protective effect. All this will disappear (protective SD=0) once the VAT and SD Act 2012 comes into effect next year.

If SD is predominantly protective, then it follows quite logically that its revenue impact is nominal. It cannot therefore serve the revenue objective if that is the intention of NBR.

However, in delivering protection, SD helps to prop up the domestic price of an import substitute as well as the competing import if it gets to the market. Then who pays this protection tax? Of course, in the end it is the consumer who pays the extra price, the producer’s profitability rises thanks to the SD, while the tax authority earns revenue from a lower import base. The problem is that if the SD rate is too high, protection may result in a de facto ban on imports resulting in little or no revenue.

Is there a way out? The Vat and SD Act of 2012, which is expected to take effect in 2016, proposes to completely wipe out the protective effect of SD, by removing SD from all but 241 tariff lines. In these tariff lines, SD will be applied according to law, i.e. equally on imports and domestic production, so that protective effect is zero. In one stroke, that will wipe out as much as one-third of the protection being enjoyed by the import substituting producers for decades.

Will it fly? I think it would be rather disruptive. Only a gradual phase out of SD – say in three years, with due notice to producers — will be feasible under the current political economy configuration. Far too many knots within knots have been added to the prevailing tariff scheme over time to allow their dismemberment in one clean stroke.