Interview: Dr. Zaidi Sattar_‘The protection of import-substituting industries is creating an anti-export bias’

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INTERVIEWS

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‘The protection of import-substituting industries is creating an anti-export bias’

The National Industrial Policy 2022 proposes high subsidies on capital investment for import-substituting industries, to make the country self-reliant in production. The Business Standard has interviewed Dr Zaidi Sattar to understand the implication of such a decision

Dr Zaidi Sattar. Sketch: TBS

Self-reliance versus international trade had occupied the centre stage of academic, as well as, political debates for much of the 20th century.

However, the rejuvenation of neoclassical economics in the 1980s followed by the fall of the Berlin Wall in the next decade eventually led to the liberalisation of markets in India and more importantly, Bangladesh, where democracy had just been restored.

Barring the existence of an all-encompassing prescription, most economists by that point agreed that gradual and careful liberalisation of trade would most likely lead to economic development in LDCs like Bangladesh.

That being said, since the birth of the country, Bangladesh had protected certain import-substituting industries — particularly those producing consumer goods like biscuits, footwear, etc., — in the hope of making the economy more absorbent of and resilient to external shocks.

More than 50 years into independent Bangladesh, the draft of the National Industrial Policy 2022 proposes even higher subsidies on capital investment for import-substituting industries, apparently to make the country self-reliant in production, reduce the costs of imports and reduce inflationary pressure.

The Business Standard spoke to Dr Zaidi Sattar, Chairman of the Policy Research Institute of Bangladesh (PRI), to discuss the implications of increased subsidies to import-substituting industries.

The government will provide subsidies to import-substituting industries (ISI). That means, locally produced import-substituting goods will become even more competitive in the domestic market. Did the ISIs need further subsidies?

The idea of subsidising import-substituting industries (ISI) is a "contradiction in terms". The existing tariff protection provided to the import-substituting industries (ISI) is itself a form of subsidy. For instance, the nominal tariff protection for the footwear industry is 86% which is equivalent to an 86% subsidy to the footwear industry.

Unlike other forms of subsidy like cash support schemes, the burden of this subsidy is borne by the consumers (not from the government budget) as the price of the products produced in these ISIs rises at least by the amount of the tariff imposed on the import of similar goods. This is essentially a transfer of resources from the consumer to the producer.

In terms of the effective tariff rate, the situation is much worse. The effective tariff rate is measured by subtracting the nominal tariff rate on input from the nominal tariff rate on output. In the case of Bangladesh, the effective tariff rate is much higher than the nominal tariff rate.

Import-substituting industries are supposed to produce import-competing goods. The whole idea of providing tariff protection to these industries — euphemistically called infant industries — was to make sure that they could survive and potentially thrive despite foreign competition if and when trade was to be liberalised and tariffs phased out.

Unfortunately in the case of Bangladesh, once tariff protection is imposed they are never lifted. It has continued year after year. The expectation behind these policies was to make infant industries internationally competitive.

Wherever protective tariff regimes have been imposed — in Bangladesh or any other part of the world — companies kept asking for more protection instead of becoming self-reliant. The result universally has been the unabated persistence of protection without regard to any timeframe or industry performance vis-à-vis development goals.

There are companies in Bangladesh that have received protection for the 50 years of independence. The government is already subsidising these industries through tariff protection. Providing more subsidies to import-substituting industries is an unorthodox idea. Subsidies are usually provided to exports because you cannot provide tariff protection to exports destined for the world market. These export subsidies, effective or not, are typically borne out of the budget.

How would this decision affect the competitiveness of export-oriented industries like RMG?

Very simply, if you are providing high tariff protection to import-substituting industries, which as I mentioned earlier, is equivalent to a much higher level of subsidy than that received by any export-oriented industry in Bangladesh.

Technically, the government does not even subsidise the RMG industry. But they do provide the industry with the scheme of importing inputs at world prices, i.e. free of duties to create a level playing field against their international competitors. This is not a benefit but an essential requirement to neutralise the cost-raising effects of a high tariff regime.

Such facilities should be expanded to all export-oriented industries instead of providing subsidies to ISI firms. Yes, RMG was given a 1% cash incentive during the Covid-19 pandemic. But this protection of the ISI is creating what may be called an 'anti-export bias'. Except for the RMG industry, most other industries have somewhat of a dual operation.

The biscuits industry used to receive 200% tariff protection some time ago but has reduced to 100%; that is still too high. Photo: courtesy

They sell goods in the domestic market and export them abroad. Now the fact that the government is heavily subsidising import-substituting domestic products through tariff protection is itself a disincentive to export.

Let's say an exporter would receive Tk500 exporting a pair of shoes. Now, one fundamental aspect people tend to forget is that firms will only export if the export prices are higher than the price received in the domestic market. But because of high tariff protection, the price of the same pair of shoes in the domestic market could be as high as Tk1000. Thus profitability of simply selling this and many other highly protected consumer goods in the domestic market is much higher than exporting the same.

Would you then say that our industrial policy and export policies contradict each other? How would it affect the export diversification efforts?

The domestic market particularly for consumer goods is already highly protected. This creates asymmetric incentives between exports and production for domestic sales by non-RMG firms. If policymakers choose to introduce more subsidies to ISI in the new industrial policy, it would contradict the existing export policy.

Bangladesh is an export-driven economy. On one hand, we want to expand our exports and encourage existing and upcoming entrepreneurs to become more export-oriented, because exports bring foreign exchange and export industries create far more jobs than those catering to the domestic market.

When non-RMG producers realise that they are better off investing their resources in the protected market, they will refrain from exporting, which will only hurt our chance of achieving export diversification and higher growth.

The authorities are saying that this decision was taken to make our production self-reliant. How would such a decision affect the current as well as long-term price levels?

It appears there is some misunderstanding about economic history and about how economies work. They are probably being influenced by protectionist lobbies. You see, protection would be justified if it is time-bound and performance-based because protection comes at a cost to the consumer who is the largest stakeholder group. No logic would justify giving protection ad infinitum.

You see, when you impose tariffs on imported products, you not only increase the price of the imported products but also the import-competing products. It's because the domestic producers no longer have an incentive to supply the goods at a lower price.

High tariff rates give them cover for charging higher prices for locally produced import substitutes. PRI research has shown that Bangladesh consumers pay an average of 70% above international prices for most consumer durable and non-durable goods.

How long should these subsidies last given the tendency of Bangladeshi companies to become reliant on such subsidies instead of becoming competitive with foreign brands?

If protection must be provided they have to be made time-bound. But that is easier said than done. The political economy of protection in Bangladesh is a study in progress. But it cannot be avoided as the nation's future growth potential is hinging on our export success, which is the only route to achieving a growth rate higher than 8% over the next two decades to reach Upper Middle-Income status by 2031 and High-Income status in the 2040s, in line with the goals of our 8th Five-Year Plan and Perspective Plan 2041.

Protection must be made time-bound and performance-based. But whenever there is a discussion regarding lifting tariff protections, the ISIs argue that they are not ready yet. This has happened over the past 30 years. The biscuits industry, for instance, used to receive 200% tariff protection some time ago. Thankfully, that has been reduced to 100%, which is still very high.

These industries have received these protections for the entire lifetime of independent Bangladesh. If they cannot become competitive, generate more employment and supply goods at a competitive price for the domestic consumers, you cannot justify providing more protection to these firms.

That is not to say we should not protect any industry at all. Companies like Walton who are venturing into the electronics market should be given some cushion against foreign competition. Even then, tariff protection for import-substituting industries should not last for more than 10 years. The rate of protective tariff (i.e., how high should it be?) is another issue for national debate. But that is better left for another day.

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