

AN EVALUATION OF TRADE POLICY

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I. Introduction

The objective of this paper is to evaluate the trade policy of the caretaker government. This policy proposes a comprehensive tariff reform to be implemented from the fiscal year 1994-95. Main features [Government of Pakistan, (1993)] of this tariff reform package are as follows:

1. Maximum tariff levels will be set at only 35 or 50 per cent with six slabs of 10, 15, 25, 35, 45 and 50 per cent. Existing tariff rates will apply to motor vehicles, alcoholic beverages, POL, wheat, fertilizers, pesticides and life savings drugs.
2. Tariff reduction will be phased in gradually over a three year period.
3. Many concessions and exemptions present in the existing tariff regime will be withdrawn gradually.
4. Tariff structure will represent a cascading of nominal tariff with progressive stages of manufacturing. Locally produced goods will be subjected to higher tariff rates compared to goods not produced domestically.
5. Tariffs on machinery and equipment will be 10 per cent unless this machinery is produced locally.
6. High priority domestic industries (such as engineering and chemicals) will receive nominal protection of 50 per cent.
7. Raw materials and intermediate goods predominantly used in the production of exports would be subjected to zero rate of duty.
8. Existing import licence fee, iqra surcharge and flood relief surcharge will be merged with the statutory tariff rates.

Before discussing the likely effect of these reforms it is necessary to review the present tariff structure.

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I. Customs Revenue Structure

Prime sources of federal government tax revenues are various kinds of import tariffs, licence fees and surcharges. In fiscal year 1992-93, revenues from these sources amounted to Rs.95 billion which is 54 per cent of total federal government tax revenues as shown in Table 1.

TABLE 1

Revenues from Import Taxes in 1992-93

	Amount (Rs. Billion)	in % of GDP	in % of Revenue
Customs Duty	60.5	4.5	34.3
Iqra Surcharge	10.3	0.8	5.8
Licence Fees	12.8	0.9	7.3
Sales Tax	11.2	0.8	6.3
Total	94.8	7.0	53.7

Due to their significant contribution to tax revenues it is apparent that government's main objective in imposing tariffs is revenue collection. Other economic objectives like providing protection to domestic industries are also considered but are not the main guiding criteria in setting tariff rates.

II. Rates-Wise Structure of Import Duties

Table 2 shows the rate-wise value of imports and import duties for the fiscal year 1991-92. First, a noticeable and very important anomaly is that a great amount of total imports (45 per cent) is not subjected to any kind of duty. This is due to various exemptions granted to different importers, specific firms, institutions and regions through various SROs over the years. These exemptions have made the effectiveness of statutory duty rates extremely low. Despite very high statutory duty rates, (0-435 per cent) the effective rate of duty which is the proportion of actual duty collection to the value of imports subjected to duty is only 33 per cent. If this rate is calculated as a proportion of total imports, it falls to a mere 18 per cent, which represents the "collected rate" of duty. Statutory rates of duty seem to have

TABLE 2
Rate-Wise Value of Imports and Duties (1991-92)

Statutory Rate of Duty	(Million Rs.)						Effective Rate of Duty
	Total Import Value	Duty Free Imports	Dutiable Imports	Import Duty	Effective Rate of Duty		
Zero to 40%	44,843	32,391	12,452	2,600	8%	21%	
40% to 90%	67,771	20,187	47,584	19,593	64%	41%	
90% to 435%	4,023	813	3,210	2,307	8%	72%	
Specific	54,955	23,977	30,978	6,220	20%	20%	
	171,592	77,368	94,224	30,720	100%	33%	
Share in Total Import Value	100%	45%	55%	18%			

Note: Figures are for Custom House Karachi representing 85% of country's total import duty collection.
Source: CBR Year Book 1991-92, p.330.

absolutely no relation with collected rates of duty. The absence of a relationship has been demonstrated by Pritchett and Sethi (1993) in a detailed study of tariff codes of Pakistan, Kenya and Jamaica.

Second, an important feature of rate-wise import duties is that the bulk of collection (64 per cent) is obtained through statutory duty rates of 40 per cent to 90 per cent. Duty rates of zero to 40 per cent and 90 per cent to 435 per cent contribute only 8 per cent each. Specific duty rates fetch a significant 20 per cent of total import duty collection.

Although the present tariff structure subjects luxury and finished goods at higher rates than essential goods and industrial raw materials, but the presence of various exemptions and concessions embedded in many SROs has made the tariff regime complex and at places contradictory. High tariff rates encourage under-invoicing and smuggling and cease to properly influence domestic producers' prices. Domestic prices become lower than the C&F import prices plus tariffs. Tariffs become redundant and resources are diverted on smuggling. This results in revenue loss to government as well as losses to domestic producers. National Taxation Reforms Commission Report, (1986) estimated that Rs.20 billion worth of goods was smuggled annually. A recent estimate puts the magnitude of smuggling to over Rs.100 billion. [Pakistan Institute of Development Economics, (1993)].

At this moment, it is useful to compare the tariff rates of other countries with ours. Maximum tariff rates for India, Pakistan and Bangladesh were over 400 per cent in 1990. Other high tariff countries were Costa Rica, Ecuador and Kenya where these rates were 300 per cent, 215 per cent and 170 per cent respectively. Thailand, Philippines and Indonesia have maximum levels of 60 per cent. Turkey's maximum tariff was 50 per cent in 1989. Korea's maximum rate was only 30 per cent and Mexico's rate was only 20 per cent in 1990.

III. Protective Structure of Tariffs

Tariffs provide protection to domestic industries by making it possible to sell at higher prices than otherwise. Industrial environment under protection entails three types of costs to the economy. Allocative inefficiency costs, X-inefficiency costs and monopoly returns permitted by higher prices. Bergsman (1974) has estimated the allocative inefficiency costs for Pakistan at only 0.5 per cent of the GNP, but the estimated costs due to monopoly returns and X-inefficiency combined were significantly larger at 5.4 per cent of the GNP. The level of protection is measured by the Effective Protective Rates (EPR) rather than nominal tariff rates. EPR is the percentage excess of value added at domestic prices over the value added at world market prices of an activity resulting from the application of different protective measures on both the output and the input side. Efficiency of protected industries is measured by Domestic Resource Cost (DRC) which is the excess domestic cost of

saving (earning) foreign exchange.

An old but very comprehensive study [Naqvi and Kemal, (1983)] by PIDE still provides very useful insights into the protective structure of tariffs. Extreme variation was found in EPRs of 90 industries. It varied from negative protection of 89 per cent to a staggeringly high positive protection of 3251 per cent. Table 3 shows the average level of protection accorded to the manufacturing sector in 1980-81. Although it seems modest at 60 per cent, but it hides the extreme variation described earlier. Table 3 shows that 13 out of 90 industries were extremely inefficient in which the value added was mostly negative. Another 31 industries suffered from very high protection, while 23 industries were moderately protected. The remaining 23 industries were negatively protected (penalized!).

TABLE 3

Average Degree of Protection (EPR)

Degree of Protection	EPR	No. of Industries
EPRs leading to negative or negligible value added.	-	13
High EPRs.	362	31
Moderate EPRs (10-80%)	34	2
Negative and low EPRs (below 10%)	- 20	23
Overall average	60	-

Source: Naqvi and Kemal, (1983), p.35.

Even though the average level of protection is quite moderate at 60 per cent, but the extreme variation is due to the complexities and inconsistencies in the tariff regime due to irrational exemptions and concessions. Presence of negative protection confirms the existence of inverse cascading in the tariff structure.

Table 4 shows the levels of inefficiency of 90 industries. DRCs higher than unity indicate inefficient industries. Unit level DRC shows that one rupee worth of domestic resources is transformed into one rupee worth of foreign exchange. Overall, the average level of DRC stood at 2.65 which shows that the domestic production of import substitutes uses up 265 per cent more inputs as compared with their production abroad. Thirteen of the 90 industries were extremely inefficient, 64 industries were close to average inefficiency level and only 13 industries were efficient. PIDE study concluded that "Pakistan's protection structure has helped

those industries most which deserved such help the least" [Naqvi and Kemal, (1983)].

TABLE 4

Average Levels of Inefficiency/Efficiency

Degree of Allocative Inefficiency/Efficiency	DRCs	No. of Industries
Extremely Inefficient	—	13
Inefficient (above 1.0)	2.80	64
Efficient (equal to or below 1.0)	0.57	13
Overall Average	2.65	

Source: Naqvi and Kemal, (1983) p.37.

Although the PIDE study is old and over the years many changes have been made in the tariff regime like the reduction of maximum tariff rates to 80 per cent (except for motor vehicles and alcoholic beverages), removal of various non-tariff barriers etc., however, the inconsistencies and anomalies described earlier are still present and have perhaps increased due to the various SROs over the years. Average EPRs have most likely declined but the variation among these EPRs has not declined. Therefore, until there is a study available on present protective structure PIDE's old study is still relevant for policy analysis.

A recent study by the World Bank (1992) shows that average EPRs in 1985-86 for three industrial sub-sectors (chemical, engineering and textile) were very moderate and ranged from 10-20 per cent. However, large dispersion was present across products with some enjoying well above 100 per cent EPR, while others suffering from negative protection. A proper trade and industrial policy is impossible to design unless a thorough study of protection is undertaken which can pin point the causes of inefficiencies and distortions.

IV. Tariff Regime and Anti-Export Bias

Some studies [World Bank, (1988)] based on the comparison of effective exchange rates faced by the import and export sectors suggest that Pakistan's trade regime is biased in favour of the import substituting sector and against the export sector. Effective exchange rates refer to nominal exchange rates adjusted to various

trade taxes, scarcity premiums and exports incentives that are in effect. EERs for the imports sector represent domestic market value of imports worth one unit of foreign exchange. These EERs do not correctly show the protective effects of trade taxes.

The concept of export bias in the context of a single economy is not very useful because this bias can be reduced by giving a plethora of incentives to export sectors without necessarily improving the performance of exports. This concept was developed by Krueger (1978) in the context of cross-country studies of trade liberalization policies to establish links between trade orientation and development. A recent survey by Edwards (1993) notes that "the literature on the subject has not always been successful in dealing with precise definitions of trade regimes, nor has it been able to handle successfully the difficult issues of measuring the type of trade orientation followed by a particular country".

PIDE's study [Naqvi and Kemal, (1983) p.3] showed clearly that "export industries are, on the average, the most inefficient of the lot, with import-competing industries ranking next to them". The study warned against favouring export industries at the expense of import-substitution industries. A study of Indian Export Incentives [Lal, (1979)] and Pakistan's own past export performance have shown that export promotion can be as inefficient and chaotic as import substitution. Export promotion policies should aim at increasing X-efficiency of export industries without much subsidization to make them internationally competitive. The real problems faced by both import competing and export industries are mostly in the realm of management, marketing, quality control, cost minimization and keeping abreast with new and cost saving technologies. Tariffs and subsidies are almost useless to remedy these problems.

V. Evaluation and Impact of Tariff Reforms

Reform package described earlier is very comprehensive and unlike any policy package of the past. Its impact on resource allocation, efficiency and protection on industries are going to be significant in the medium to long run. Short run impacts will be on revenues and balance of current account.

VI. Impact on Industrial Protection

Broad based reductions in tariff rates are neither necessary nor sufficient to move the protective structure in a better direction. However, reform package does contain significant proposals to contain the high variation in EPRs described earlier. These mostly refer to the gradual removal of discriminatory exemptions and concessions and cascading of nominal tariff with rising stages of manufacturing. These proposals are likely to diminish the anomalous phenomena of negative protection. Lower and less variant protective rates will force the domestic industries to become more efficient. Displacement effects can be significant, as the reform package [Govern-

ment of Pakistan, (1993)] estimates EPRs to decline from 212 per cent to 127 per cent. Some highly inefficient industrial units will close down. This will result in loss of employment which can only improve in the medium to long run when resources are diverted to more efficient industries. However, phased reduction of tariffs over three years is likely to lessen the costly displacement effects.

VII. Impact on the Current Account

Report of the tariff reforms committee envisages that "the tariff reform is unlikely to have a significant impact on the current account balance in the 50 per cent maximum case". Committee's views are based on a World Bank (1992) report which states "In Pakistan, the trade reform of past few years have not led to a surge in imports. In FY 89, the debanning of 162 categories from the Restricted list, and a 3 percentage point fall in the average statutory custom duty did not cause a jump in imports".

The reason that trade reforms of the past few years have not resulted in a surge in imports is mainly due to the fact that tariff reductions resulted mostly in removing the redundancies in tariffs which were very high. We have seen in Table 2 that imports which are subjected to a duty of more than 90 per cent are only 3 per cent of total imports as such tariff reductions of the past few years which have brought down tariffs to a maximum of 90 per cent were unable to increase imports. But the tariff reductions of the recent package are going to hit 65 per cent of total imports and therefore, the import expansion effects as a result of decreased domestic prices of imports can be enormous. In the absence of reliable estimates of import elasticities it is difficult to predict the resulting increase in imports. However, based on the past data [Government of Pakistan, (1992-93)], increase in imports of machinery from Rs.30 billion in 1990-91 to Rs.55 billion in 1991-92 when its unit value index declined from 583 to 579, one can only bet on high rather than low import elasticities. Therefore, it is more likely that a big surge can be seen in imports although the surge will be graduated due to the phasing of tariff reductions over three years.

The tariff package aims to reduce the bias against exports by placing all primary and intermediate inputs used in exports at zero rates of duty. We have seen that the presumption of existing anti-export bias is not entirely correct. This perception is mostly the result of poor performance of exports. Despite a plethora of export incentives like duty drawback and concessionary export finance, poor performance indicates other distortions and problems which cannot be corrected by explicit or implicit trade subsidies. Export industries are uncompetitive internationally due to greater X-inefficiencies. Direct subsidies on production designed to correct the X-inefficiencies and improvement of technology are more suited to promote exports, but these policies demand careful formulation and proper implementation and monitoring.

Although the proposal to replace duty drawbacks with zero import duty is a correct step, but it will not itself be sufficient to induce better export performance. This does not augur well as imports will be rising much faster than exports. This scenario will adversely affect the current account balance and would most likely force the government to further devalue the rupee after 1994-95 when the reform is implemented.

VIII. Impact on Revenue

Tariff reforms committee, using the sophisticated CBR-AERC Model, has estimated the loss in revenue to be Rs.34.5 billion in the case of tariff reductions to a maximum 50 per cent and 38.6 billion in the case of a minimum 35 per cent. This loss is considerable and to make the reform revenue effect neutral, various exemptions have to be removed and broad basing of sales tax be undertaken so that extra revenues can be generated. In the absence of any other alternative at present, it is not possible to assess the quality of these estimates. However, since this is the area where government is likely to be hurt most, it is reasonable to expect that these estimates are realistic.

IX. Conclusion

Strength of the reform lies in measures enhancing greater industrial efficiency and better resource allocation. Lower protection will result in better allocative efficiency and as Bergsman (1974) has shown that this competitive environment results in the reduction of X-inefficiency as well. Less protection will not only result in better allocation of resources but cost minimization pressures due to international as well as domestic competition will reduce X-inefficiency and monopoly costs, which are presumably much higher in Pakistan. There is a likelihood that lower tariffs in the short run can cause balance of payment difficulties as well as displacement costs. The phased reduction of tariffs and gradual withdrawal of exemptions is likely to lessen these costs. The long run benefits of the reforms are likely to outweigh its costs by a significant margin.

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