Bangladesh

Improving Competitiveness through Trade Policy Reforms

In an increasingly competitive, globalizing world, Bangladesh needs to rationalize its tariff structure and lower overall protection so that its exports can compete in world markets. At the same time, the government needs to protect revenues in a fiscally-constrained year. This note proposes a package of tariff reforms that simplifies the rate structure, lowers average nominal protection, improves economic efficiency and is virtually revenue neutral. Adverse revenue impact, if there are any, could be addressed by strengthening the Large Taxpayers Units, reducing the numerous exemptions in VAT, and expanding the tax base.

In a clear departure from the highly protectionist, inward-looking import substitution policies of earlier decades, Bangladesh has since 1991 been liberalizing its trade regime. Reform measures have included reduction and rationalization of tariffs, removal of quantitative restrictions (QRs), and adoption of a unified exchange rate system. Exports grew at 13 percent a year, per capita GDP accelerated by one percentage point every decade—it is now growing at four percent a year—and poverty declined substantially.

Notwithstanding recent efforts, trade protection in Bangladesh is still quite high relative to a number of other low- and middle-income countries that are its competitors in international markets. This puts Bangladeshi firms at a disadvantage since they face higher costs for imported inputs than do their competitors. An example of this can be seen in garment industry. This industry was spared the protective trade regime quite early on and as a consequence has flourished in Bangladesh. Faced with a more protective import regime, other industries did not show a similar dynamism. In addition to the lost economic opportunity, this has also resulted in some vulnerability in the form of heavy concentration of exports in one commodity, garments, which accounts for 75 percent of total exports.

Besides high protection levels, tariffs in Bangladesh also have an escalating structure. Customs duties rise according to stages of production, being the highest for consumer goods. This means that the effective rates of protection for import-substituting final goods are even higher than the nominal tariff protection on these products. This results in diversion of precious domestic resources toward the import-substituting sectors, at considerable cost to the economy—somewhat akin to what India suffered by protecting, for example, its car industry until the early 1990s. But India and a number of other developing countries have since moved much more decisively on trade liberalization, and have reaped the benefits in the form of more diversified export baskets, robust export growth, significant efficiency gains, and more satisfied consumers who are enjoying more choice, better quality, and lower prices – the consumers of cars in India would readily attest to that.

Bangladesh has much to gain from today’s rapidly globalizing world, where production supply chains are constantly shifting across developing-country borders in search of cheaper and productive labor. The prize is the vast global market and the employment- and growth-enhancing investment in labor-intensive manufacturing. But global competition for such opportunities is commensurate with the magnitude of the potential gains. Bangladesh’s competitors (China, India, Vietnam, among others) appear to have understood this and are already far ahead in the game. Bangladesh has some catching-up to do, and more decisive and timely action is now required.

Against this background and with a view of furthering economic reforms, this note proposes a few policy options to reform Bangladesh’s trade regime and make it more competitive. The proposal is mindful of

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the fact that any trade liberalization proposal, given the low revenue situation in the country, needs to be revenue neutral.

I. Trade Policy Reform: Bangladesh vis-à-vis other South Asian Countries

Today, Bangladesh has the most restrictive trade regime among the major South Asian countries. India held that distinction until it removed all QRs in April 2001 and continued to lower and rationalize its import duties, particularly on manufacturing goods. As of February, 2007, the top general level of non-agricultural tariffs in India stood at 12%, though agricultural tariffs are still higher. India’s average protective tariff is around 13.5% compared to Bangladesh’s average of 24.3%. While India and Pakistan have done away with most para-tariffs, Bangladesh relies on a large array of these to bolster revenue or add to trade protection. More than a third of its average nominal protection can be accounted for by these para-tariffs (see Figure 1). Though the top customs duty (CD) rate came down to 25% in FY05, it gives a misleading impression of protection levels since a good number of consumer goods (for example, dairy and bakery products, beverages, sugar, dry cell batteries, textile fabrics, toys and furniture) are subject to extremely high protective tariffs, ranging from 50% to 140%, made possible with the imposition of para tariffs such as supplementary duties (SD) and the infrastructure development surcharge (IDSC).

In short, there is a clear need for further liberalization to improve Bangladesh’s competitiveness by reducing protection and minimizing the anti-export bias of the tariff regime. The past reduction in the top CD rate was a necessary but not sufficient condition for reduction of effective protection. Evidence indicates that for a wide range of domestic industries, reduction in the top CD rate had been more than compensated by introduction of protective taxes and levies (e.g., SD, IDSC, and even protective applications of VAT).

II. A Proposal of Tariff Rationalization to Enhance Competitiveness in Bangladesh

The current import duty structure consists of the following:

- Four rates of CDs: 0%, 5%, 12% and 25%;
- A 4% IDSC on all but a few exempt commodities (since resources from this surcharge are not earmarked, this simply acts as an additional rate of import duty); and
• SD of 15%, 25%, 65% and 100-plus %.

The following proposal seeks to rationalize the tariff structure. Extensive simulations done for this tariff proposal show that it has little impact on revenue collection:

• Eliminate IDSC and merge it with the CD -- the new (IDSC inclusive) CD rates would become 4%, 9%, 16% and 29%;
• Rationalize the new CD rates to 10%, 15%, and 25%. This means that the IDSC-inclusive CD rates of 4% and 9% become 10%, the IDSC-inclusive rate of 16% is reduced to 15%, and the IDSC-inclusive rate of 29% is reduced to 25%;
• Scale back SD by reducing the 25% rate to 15% and the existing 15% to 0%; and
• To keep prices of essentials under control, zero rates to remain only on essential imports (e.g. food grain, medicines, fertilizer, cotton)

The projected impact on revenue and protection of this proposal is presented below in Table 1:

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<tr>
<th>Table 1: Impact on Revenue and Protection in FY08</th>
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<td>Case I. No change in policy</td>
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<td>Case II. Rationalized Duty Structure of 0%, 10%, 15% and 25%</td>
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A. Revenue. The proposed reform option involves both revenue gains and losses on account of changes in the rate structure. Scaling down of the top rates could lead to revenue losses in a static sense, but one needs to consider two things: (a) there will be revenue gains from trend growth of imports, regardless of tariff changes, and (b) there will be a positive response of imports to the tariff reduction (elasticity effect) and consequent revenue gains. Likewise, the scaling up of the bottom rates would have an ambiguous effect on revenues.

With the new tariff proposal, the projected customs revenue growth in FY08 is estimated at 13% or Tk. 2000 crore, which is barely 1% point lower than the case when there is no policy change. While reliable estimates of elasticities are not available at the moment, the elasticity effect is unlikely to yield significantly lower revenues, and may even yield higher revenues.

B. Protection. Under the present structure of tariffs, average nominal protection works out to 24.3%. A noteworthy feature of the proposal is that it would constitute a major step toward dismantling para-tariffs, which account for more than one-third of the average nominal protection. The proposed option, if implemented, would bring average nominal protection down to 20.8%, while also lowering the effective rate of protection.

Thus, the proposal is almost revenue neutral. Revenue losses might be greater if import growth falls below trend or leakages from customs assume undue proportions. It is expected that any potential revenue loss from customs can be easily made up from domestic taxes – VAT and income tax – where the scope
for revenue increase from expanding the tax base (through organizational improvements, innovation, automation and business process changes, and eliminating a plethora of tax exemptions) remains enormous.\(^2\) This would also result in the desired strategic shift from reliance on import-based taxes to domestic taxes.

\(^2\) An analysis of “tax expenditures” done recently by Bangladesh Bank found that reductions in tax liabilities resulting from various tax preferences such as preferential tax rates, exemptions, deductions, rebates, deferral, credits etc. amounted to 31.3% of revenue earnings and 2.5% of GDP in Bangladesh in FY05. Major portion of tax expenditures comes from indirect taxes, particularly VAT at domestic stage which alone accounted for 1.6% of GDP revenue loss. See M. Golam Mortaza and Lutfunnahar Begum, "Tax Expenditures in Bangladesh: An Introductory Analysis," Policy Note Series: PN 0706, Policy Analysis Unit, Bangladesh Bank, December, 2006.