

Analysing the National Tariff Policy

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INTRODUCTION

Customs Tariff

What is the role of import tariffs in a modern economy? Tariffs may seem an easy source of revenue, but they do have real consequences for the economy. The use of tariffs makes imported goods more expensive. It can be used as a means to prevent the exchange rate from fully adjusting to market value reducing incentives for export while increasing incentives for import substitution. Tariff policy can thus affect the product mix of country, including its direction of industrialisation, which in the complex globalised world of today determines its place in the global value chain.

Under the Federal Government Rules of Business, 1973, the Customs Tariff Policy and protection regime is the mandate of the Ministry of Commerce. However, over the years, except for trade defence measures, the Federal Board of Revenue (FBR) had assumed an overwhelming role in tariff setting. As a result, tariff became one of the primary tools for raising revenue rather than for protecting local industries or promoting international trade.

In order to bring better balance in tariff setting policies, recently the government decided to set up a Tariff Policy Board (TPB) chaired by the Commerce Minister/Advisor, with Minister for Industries and Production, Secretary Finance, Secretary Revenue, Chairman FBR, Secretary Commerce, Secretary Board of Investment, and Chairman NTC as its members. A Tariff Policy Centre (technical) has been created in the National Tariff Commission, which will hold consultation with stakeholders, analyse the proposals, and formulate Tariff Policy to be submitted to the Tariff Policy Board.

With this new set-up, it is hoped that the Tariff Policy Board will be able to develop a coherent vision for tariff policies and clearly lay out important tariff policy goals.

Need for a National Tariff Policy

The National Tariff Policy 2019-24 has identified several issues in the existing tariff regime. Traditionally, Statutory Regulatory Orders (SROs) that grant exemptions to

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specific industries have been the key source of deviations from MFN tariff rates. These exemptions greatly complicate the reporting and analysis of the country's tariff profile (level and structure of tariffs). They also do not affect the customs duty rate reported in the tariff schedule². Moreover, since the exemptions are applied for specific instances or use cases of products, in principle two customs duties rates can apply to the same product being imported³ for different uses.

Issues in the existing tariff regime

- Focus on tariffs as a revenue tool has:
 - created distortions
 - eroded competitiveness
 - increased cost of inputs
- High tariffs have:
 - Created inefficiencies in manufacturing sector
 - Anti-export bias
 - Burden of protection on consumers
 - Incentive of smuggling, under-invoicing, mis-declaration of goods
- Excessively complex tariff structure due to:
 - Multiple duty slabs
 - High tariffs
 - Concessionary SROs
 - Regulatory duties
- Differential tariffs imposed for same inputs used by multiple industries – creates anomalies and discrimination
- Regulatory duties imposed have made tariff structure inconsistent and unpredictable

Source: Government of Pakistan (2019). "National Tariff Policy 2019-24", Section 4.

There is also substantial positive escalation evident in Pakistan's tariff profile, with the tariff rate increasing as the level of value addition of the product increases. WTO's Trade Policy Review of 2015 attributed this to a policy preference for protecting the domestic industry (the infant industry argument). Finally, the report has also identified that average tariffs for specific industrial and even agricultural products are higher than the average for the sector overall. As pointed out in both the NTP 2019-24 policy and the WTO Review, the large gap between average bound and applied tariff rates reduces predictability and consistency in the country's tariff regime.

Pakistan started the liberalisation process in the 1990s but there have also been many reversals. Most of the reforms done during 1997-2002, were reversed following the 2008 global financial crisis. Moreover, the signing and implementation of various bilateral preferential trading agreements (with China, Sri Lanka, and other South Asian economies) have resulted in growing complexity of the tariff system, rather than simplification.

²*Source:* WTO (2015).

³*Source:* Pursell, Khan and Gulzar (2011).

According to Nasir (2020), the high incidence of taxes on imports creates an incentive for importers to under-declare, mis-declare, and resort to smuggling. International research by Fisman and Wei (2004) has argued that increasing tariffs by 1 percent will lead to a 3 percent increase in evasion. In the case of Pakistan, revenue loss to the national exchequer from tariffs is considered to be substantial. Qureshi and Mahmood (2016) have pegged the loss at USD 21.1 billion for the period 1972 to 2013, while National Tariff Commission's PTA Report estimated that smuggling was 43 percent of total market demand and exceeded official (regular) imports. These are substantial losses that the domestic economy is ill-equipped to bear for much longer.

Against this backdrop, it is expected that the new National Tariff Policy will be able to address these issues so that the domestic economy can benefit from having a tariff regime that is uniform and low, and relatively free of distortions.

Guiding Principles and Salient Features of the Policy

The National Tariff Policy 2019-24 was approved in November 2019 and was the result of a year-long consultative effort by the Ministry of Commerce. The guiding principles of this policy include the intent to reorient tariffs as an instrument to promote trade and remove an anti-export bias in policy. Furthermore, tariffs will no longer be used as a means of generating revenue for the government.

Guiding Principles of NTP 2019-24
<ul style="list-style-type: none"> • Abandoning revenue generation as a tariff policy agenda and policy goal • Recognising the use of tariffs as an instrument of trade policy and promotion • Focusing on removing anti-export bias in tariff regime

The policy has laid out a tariff reform agenda that is designed to promote trade through an efficient allocation of resources, remove distortions in the domestic economy, and create a competitive environment for domestic industry. This is in line with the recommendations made by a 2018 World Bank Report on leveraging private sector growth in Pakistan by promoting trade and investment competitiveness (Rocha and Varela, (2018). The new policy has identified this as being accomplished through the principles of cascading tariffs, strategic protection, and import substitution, which are not new nor are they without their pros and cons, as discussed below.

A Critical Review of the Policy

The National Tariff Policy seeks to rationalise tariffs by continuing with some of the past practices such as cascading tariff, protection of domestic industries, and strategic protection. Given that the policy seeks to move away from previous policy imperatives, it is important that to the extent possible, these policies are phased out over time. Given that the past efforts have had limited success, the NTP should follow the trends prevailing in successful exporting countries.

Over the past several decades, tariffs were frequently raised to benefit local producers by artificially raising the prices of imported goods above domestic prices. It

was expected that this rise in prices should encourage local production of otherwise imported goods. However, the experience was that these increases in tariffs made the local industry inefficient and unable to compete in the international markets.

The NTP specifically lists three principles that will be retained to benefit the local industry. Each of these principles and how they can defeat the purpose of tariff reforms is discussed below.

Cascading: While the principle of cascading is important to promote domestic value addition, care must be taken to avoid providing too much protection to downstream industries. Previously, too much protection through cascading was provided to key sectors that failed to grow and stagnated with weak productivity growth because of weak incentives to become competitive.

While the Pakistan Business Council (PBC) in its presentation to the government on “Make in Pakistan”, proposed cascading tariffs as necessary for reviving the manufacturing sector, this view does not take into account consumer welfare. For this reason, the government should research the efficacy of cascade tax for not just the domestic industry, but also for the domestic consumers, in keeping with the objectives of the NTP 2019-24.

A cascaded tax or tariff ends up being a tax on top of a tax. That being the case, a tariff cascade would have a compound effect, with the final rate being higher than the initial rate charged upstream.

Thus, a cascaded tariff structure is not a panacea for boosting the domestic manufacturing sector. Rather, tariff cascading may promote rent-seeking, reduce productivity, and hurt consumer welfare by restricting market competition. It is thus important to rethink the imposition of a cascaded tariff structure and introduce a tariff policy that not only provides the right incentives to producers but also promotes the interests of the consumers.

Quite often cascading creates other anomalies. Often finished product for one industry is a raw material for another. For example, if the cascading principle is applied to the raw material of steel sheets and finished machinery, tariff rates on machinery would have to be enhanced. Another example is of paper which currently is subject to high tariffs. In terms of cascading, books made from paper would have to be subjected to even higher tariffs. High tariffs on essential goods such as machinery and books would create serious problems for other sectors. Thus, the cascading principle does not work in most of the cases.

Other countries such as the East Asian Tigers also adopted protectionist measures early in their development, but these measures were for a short predetermined period. In case of Pakistan, once an industry is given protection for a certain period, it is not easy to lower the protection rates. As a result, such industries have remained infant for decades. They could only cater to domestic demand through high tariffs and not be able to export.

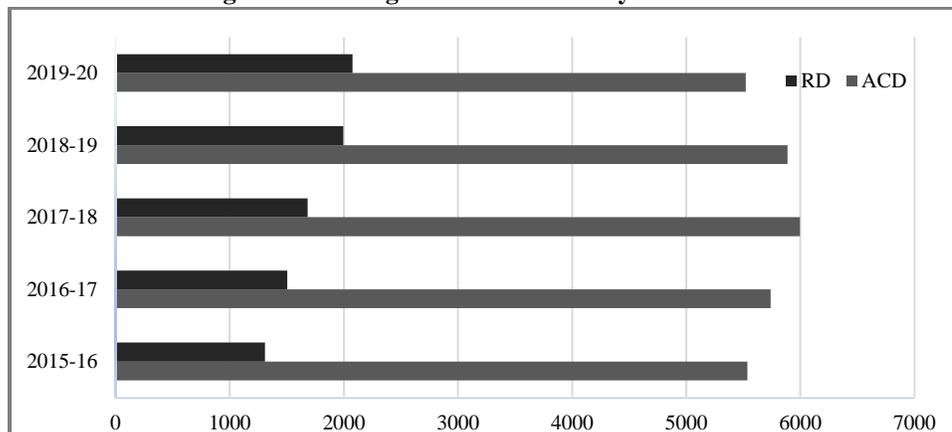
Protection for Import Substitution: The level of protection to import-substituting industries need to be properly rationalised to balance the interests of consumers and producers. Tariff reduction will have a benefit for consumers through lower price of imports and access to a greater variety at lower prices, and this should be highlighted by the government. If the domestic market continues to be closed to imports by prohibitively high tariffs, it is likely that the tariff jumping investments would create wasteful excess capacity as has happened in the past. Such misallocation of resources hampers productivity and stunts overall economic growth. Pakistan's experience is that whichever industry was given high protection, it never became competitive. Auto, sugar, and paper industries are some of the examples.

Strategic Protection: The Policy mentions that strategic protection will be provided to domestic industries to protect them from foreign competition. It will be offered to industries in the infancy stage to lower the cost of doing business and is planned to be time-bound and phased out to encourage competition. However, our past performance in this regard is not promising. Industries are still receiving handouts from the government, and timelines are easily revised on one pretext or the other. Unless effectively implemented, this is going to create an additional drain on our already limited resources.

It is not clear how the domestic industries will be selected for protection. In this context, it is important to spell out at the outset clear guidelines on how and what industries will be provided strategic protection. Moreover, improving, or at the very least maintaining quality, must also be a requisite for protection. In the past, such initiatives have merely contributed to rent-seeking while failing to establish a strong and competitive industrial sector.

Competitive import substitution is going to be encouraged under the policy, but again the policy document is light on the modalities of how it will all work, not to mention the fact that it becomes hard to justify how the tariff structure is being simplified and prone to fewer distortions. In the past, SROs have been used in addition to tariffs to achieve protectionist goals. How will this work when certain industries are receiving strategic protection while others are benefiting from competitive import substitution, and all are going to be subject to different time bounds?

Fig. 10. Coverage of ACD and RD by Tariff Lines



Source: Nasir (2020).

Various interest groups exert pressure on the government to impose additional customs duty (ACD) and regulatory duty (RD) on imports to discourage competition. These duties introduce anomalies in the country's tariff profile and do not work in the interest of domestic consumers. Instances of these abnormalities have increased in recent years, as evidenced by the increasing number of tariff lines subject to these duties.

Policy Process: The new policies of the government focusing on enhancing exports, encouraging foreign investment, and Pakistan's integration into the global value chain must all stem from a common holistic view and approach so the most efficient and optimal outcome is achieved.

Recommendations

- The policy must now be accompanied with a more concrete action plan that puts all on notice on how to proceed.
- Policy has announced good intentions. But a lot needs to be done to make it happen. We have had tariff liberalisation in the past only to be reversed. We should have a clear plan with timelines and a clear transparent immutable information plan.
- Openness is necessary for local competition. Our National Tariff Policy must be synced with our competition policy at home. This is an important exercise that must quickly be initiated and developed in concrete form.
- Our protection policy has never been clearly enunciated other than to say that it should be temporary. But it has never been as announced. We should now go beyond announcements and actually announce an implementation plan with timelines and with pre-commitment.
- Tax expenditures have not only exacerbated the fiscal problem but also led to local monopolies at the expense of domestic competition. This must be an important part of the NTP going forward. Tax exemptions should not happen!

The Tariff Policy Board will only be successful if the Ministry of Commerce is given the pre-eminent role as has so far been enjoyed by the Ministry of Finance and FBR. Tariffs should be set up to promote exports and making Pakistan a part of Global Value Chain. The role of tariffs for collection of revenue should be limited as is the case in other successful developing countries.

Finally, there is a need for institutionalising proper mechanisms for getting feedback from evidence-based policy research. In this context, it is important to include in the tariff policy board (TPB) relevant experts from the academic community and policy think tanks who can provide research-based input into tariff policymaking. Also, the inclusion of representatives from the private sector would create stake-holding among the relevant players leading to greater ownership by the market participants.

Conclusion: Will the new policy achieve its goals?

The new National Tariff Policy has laid out a comprehensive tariff reforms agenda to promote an efficient allocation of resources, remove distortions, and create a competitive environment. The policy has highlighted laudable steps including abandoning the revenue generation as a goal of tariffs, recognition of tariffs as instruments of trade policy to promote trade and industrial competitiveness, and the overall thrust on the removal of anti-export bias. However, details are yet to emerge: the policy does not give us clarity on a time frame or a path of implementation. We hope as argued here that some of these details will emerge to lead Pakistan to a consumer-focused export economy away from the current emphasis on “60-year old infant industries” at the cost of our own people.

We are glad the policy has clarified issues that academics and researchers had been asking for a long time now. It is time now to move beyond goals and move in the direction of systematically opening out the economy, removing the RDs and ADCs, eliminating the SROs and a rationalising of tariff policy so that protection is temporary and does not become rent-seeking. Until then we can celebrate the policy announcement recognising that many such announcements have not succeeded in policy escaping capture.

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