

REGULATION AND POLICY SPACE



Cascading Tariffs Are Not A Magic Pill for Pakistan

By Usman Qadir

The new National Tariff Policy 2019-24 has four key goals, one of which is improving consumer welfare by reducing the burden of excessive protection. The policy in turn is based on five guiding principles; use of tariffs as a trade policy measure; simplification of the existing tariff structure; retaining cascading tariff structure; use of tariffs for strategic protection of domestic industries; and competitive import substitution. No doubt all five principles are of importance, but one stands out in the context of improving consumer welfare, and that is cascading tariff structure. The nexus of these features is a matter that should concern the public and should not be overlooked. Let's consider why it is important to research and consider this further.

First, what does tariff cascading mean and second, what does it imply for consumer welfare. Tariff Cascading is also referred to as tariff escalation in the literature and refers to a situation in which a country imposes tariffs in a way that the rate on import of primary or un-processed products or inputs is less than the tariff on relatively more processed products or inputs and even the final good that uses such products in the production process. This cascading nature that coincides with the degree of processing or value addition is where the tariff gets its name from. Or as defined by the WTO, tariff escalation is the instance of having higher import duty on semi-processed products than raw materials, and even higher duty on finished products.

This cascading or escalation in effect stifles competition and protects domestic processing industries since they can price their products cheaper than the imported product. The lack of competition is detrimental to the economy as it erodes the incentives for producers to improve productivity. It also reduces consumer welfare by restricting their choices. Furthermore, tariff escalation serves as a disincentive for countries that supply raw materials to develop industries to process those materials.

This is problematic for Pakistan on at least two counts; one, our own experience with protection has been very lackluster; only a handful (at best) of firms have emerged competitive while the rest have been hooked on seeking hand-outs. Do we really want to create a situation where more firms are taking hand-outs?

Second, given recent developments in the world trade system, it is highly likely our imports will also be subjected to cascading tariffs in retaliation. Given we are a developing country and we still export raw materials and semi-processed products, it is logical to assume our exports will suffer.

⁷ WTO Glossary: https://www.wto.org/english/thewto_e/glossary_e/glossary_e.htm

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Clearly, 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.

Coming to the matter of consumer welfare, cascading tariffs or tariff escalation will raise the final price of a product that the consumer purchases. The producer will pass along the higher cost of the tariff down the production chain till the consumer is faced with a higher priced product. Logically, this suggests that consumer welfare will be negatively affected. A significant number of countries have shifted to a GST or VAT in place of a cascading tariff structure which has resulted in lower prices being charged of consumers. VAT is a consumption tax, on the purchase and thus consumption of a product or service. Moreover, research on the welfare impact of cascading protection has suggested that cascading protection causes additional welfare losses and vertical linkages must be explored and taken into account when formulating trade related policies.

The notion of cascading tariff structure has been proposed a means of maintaining vertical consistency. An underlying, and apparently unspoken motivation appears to be encouraging productivity and competitiveness in the domestic manufacturing sector; however, the IMF has found such a structure as a major obstacle to expansion of exports. Moreover, there is no basis for this notion in economic theory and will create distortions in the economy. This makes it difficult to reconcile cascading tariffs with export promotion on the one hand, and enhanced consumer welfare on the other.

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 clearly 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 domestic consumers, in keeping with the objectives of the NTP 2019-24.

To sum up, 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.

⁸ Erbahar, Aksel and Zi, Yuan (2017) "Cascading Trade Protection: Evidence from the US", Journal of International Economics, Vol. 108, September, pp. 274-299

⁹ <https://www.imf.org/external/pubs/ft/fandd/2006/12/gupta.htm>

¹⁰ Pursell, Gary; Khan, Ashraf, and Gulzar, Saad (2001), "Pakistan's Trade Policies: Future Directions", International Growth Centre, Working paper, June 2001.