The Mountain Gave Birth to a Mouse

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The recent Budget under consideration by the Parliament includes some import duty reforms. These reforms are pro-business, although not necessarily pro-efficiency-based growth. Bolder reforms are needed to put productivity at the forefront of Pakistan's growth agenda.

The FY21/22 Budget presented to Parliament includes import duty reforms that are both wide in coverage, but mild in depth. There are 3,128 tariff lines for which import duty changes are proposed (out of a total of 7,627). In most cases, the duty change implies a reduction. Yet, altogether, the changes make up to an average reduction of import duties of only 5 percent: going from 21.12 percent on average, to 20.07 percent. The mountain gave birth to a mouse.

The import duty changes proposed in the budget are not uniform. Neither by type of good nor by sector. Table 1 shows the before and after FY21/22 Budget average import duty by type of good and by type of import duty (customs, additional customs, or regulatory duty, CD, ACD, RD). The largest reductions are observed for industrial supplies, whose average import duty falls by more than 10 percent. Import duties on food and beverages and on consumer goods are virtually unchanged, with reductions of about 2 percent. Sectorally, the bulk of the import duty reductions focus on inputs for textile and apparel, pharma (mainly with changes in the 5th schedule) and iron and steel.

	Average import duties pre-Budget FY21/22				Average import duties post-Budget FY21/22			
	CD	ACD	RD	Total	CD	ACD	RD	Total
TOTAL	12.78	3.68	4.67	21.12	12.29	3.19	4.60	20.07
Food and beverages	14.68	4.43	12.75	31.87	14.65	4.00	12.71	31.36
Industrial supplies n.e.s.	9.92	3.01	2.34	15.28	8.98	2.45	2.21	13.63
Fuels and lubricants	8.04	2.64	0.07	10.76	7.87	2.37	0.07	10.31
Capital goods (excl. Transport)	8.27	2.51	0.77	11.55	8.16	2.30	0.78	11.24
Transport equipment	35.89	5.97	3.87	45.73	35.89	5.82	3.87	45.58
Consumer goods n.e.s.	17.39	5.96	11.75	35.10	17.32	5.14	11.75	34.21
Goods n.e.s.	14.93	4.55	2.00	21.48	14.93	4.25	2.00	21.18

Source: Authors' elaboration based on FBR, WITS.

What can we expect from this reform?

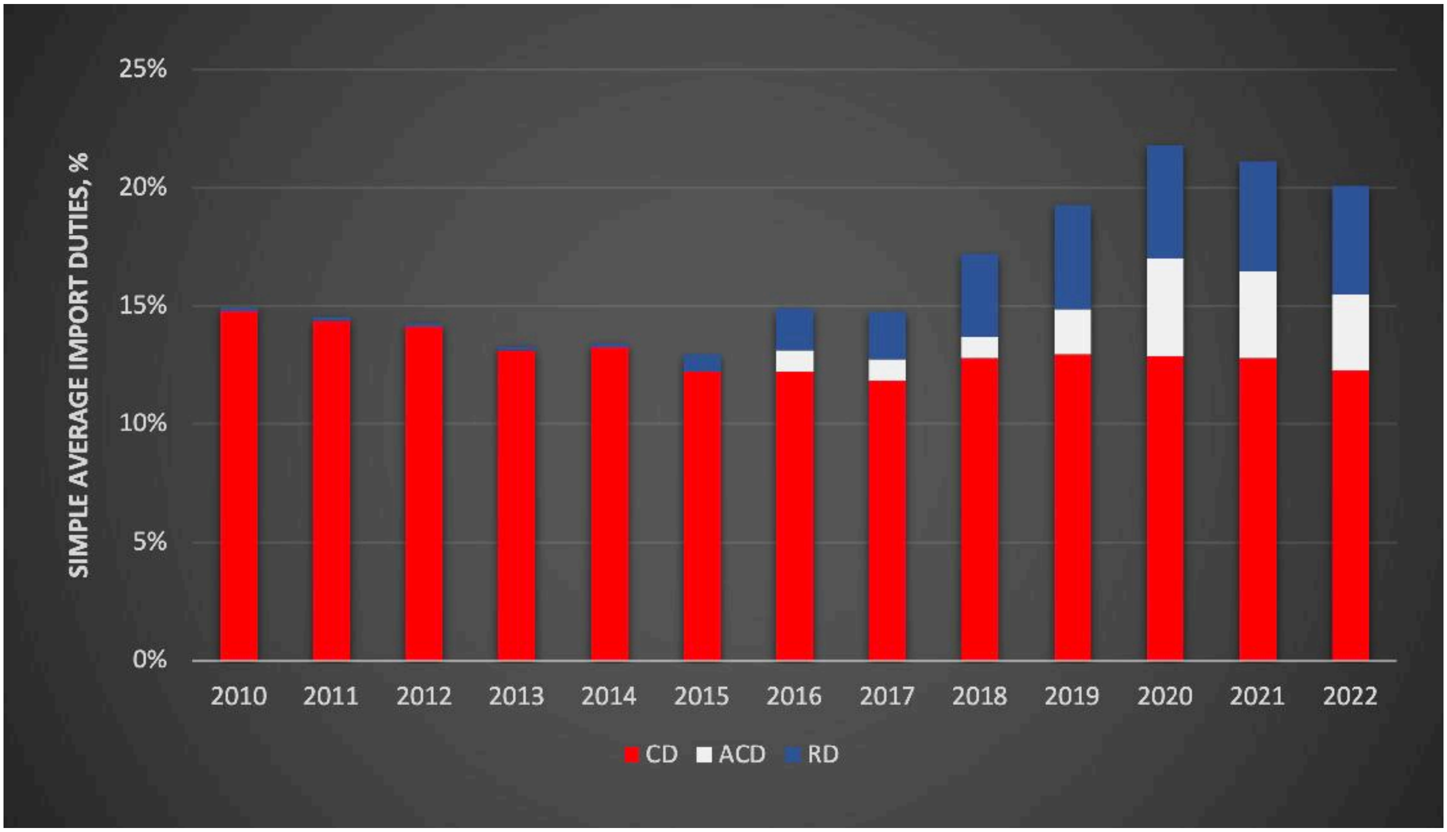
To assess the expected effects of this reform, it is necessary to distinguish its two different dimensions: the size of the change, and its composition.

The size of the change: timid

The most salient feature of the import duty reform is that it is timid. To better understand that, it is important to examine the starting point of import duties in Pakistan. They are high and have been increasing. Import duties have increased substantially since 2015. Mainly because of the introduction of other duties that, just like customs duties, discriminate by origin: RDs and ACDs. So, while there has been an effort to reduce customs duties, which fell from an average of 14.8 percent in 2010 to 12.78 in 2021, this effort has been completely reversed by the introduction of these ad-hoc RDs and ACDs that add to the already high trade frictions. During the same period ACDs increased from 0 to 3.7 percent, while RDs from 0.1 to 4.7 percent. The increased role that ACDs and RDs have on total import duties is troublesome, not just because they add to trade costs, but also because they do not require parliamentary approval to be introduced, and because they add uncertainty to overall protection (for example, unlike for CDs, there are no historical series of RDs and ACDs. The series presented in Figure 1 were constructed after a laborious process of examining all trade related, pdf-recorded, SROs since 2010).

Thus, the 5 percent reduction of average duties in this Budget does not substantially change the fact that Pakistan is among the top 10 most protected economies in the world. It also does not change the fact that protection has increased, rather than decreased in the past luster. If anything, this timid reform stabilizes protection at a level of 20 percent. In practical terms, it means that policies allow prices of tradable goods in Pakistan being, on average, 20 percent more expensive than in the rest of the world. To the expense of firms and households.

Figure 1: Import duties started increasing substantially after 2015, despite a gradual reduction in customs duties, due to the increasing importance of regulatory and additional customs duties



Source: Author's elaboration based on FBR, NTC, WITS

The composition of the change: not giving the best incentives

The import duty reform introduced in the Budget focuses most of the import duty reductions on industrial supplies (intermediates), with specific emphasis on those for textiles and apparel and iron and steel (and some changes in pharmaceuticals in the 5th schedule). In principle, import duty reductions on intermediates are productivity-enhancing because they allow firms to choose inputs from a wider pool of options (not just the domestic versions, but also the imported ones). However, if the import duty on the final good remains high, while that one on the intermediate good falls, the effective rate of protection the industry faces increases, while the incentives to improve efficiency or innovate or export do not. Thus, an import duty reduction that places most of the effort on intermediates is certainly pro-business – in the sense that it will increase their profit margins – but it is not pro-competition, pro-exports, or pro-efficiency.

Indeed, the import duty reforms in the budget do not sufficiently address the marked anti-export, and anti-new biases of tariff policy.
First, because it increases effective protection in domestic markets, the reform reduces the incentive of firms to venture into competitive global markets, in which they do not face protection. Rather, the reform increases relative profits of firms selling domestically, in detriment of those that export, hence the anti-export bias. To put these concepts in perspective: the reduction of import duties on intermediates in this budget is 4.3 times greater than the reduction of import duties on consumer goods (Figure 2). To be sure, the Budget also introduces some mild reductions in import duties on some final, consumer goods, with the reduction of ACDs from 7 to 6 percent for those tariff lines that enjoy the highest level of protection (20 percent custom duty or more). While this is a step in the right direction. It is a very small step, when compared with the reductions introduced for duties on inputs.

Second, because the bulk of the fiscal effort associated with import duty reductions in this Budget focuses on the inputs for well-established sectors, such as textiles and apparel (Figure 3), the reform favors resource re-allocations into these sectors, rather than sectors that would facilitate a process of diversification or innovation, hence, the anti-new bias. Indeed, import duties on intermediates for textile and apparel fall by 19.9 percent, for iron and steel by 9.6 percent, and for all other sectors by about 7.7 percent.

Figure 2: The pronounced and stable cascading of import duties show the anti-export bias of tariff policy

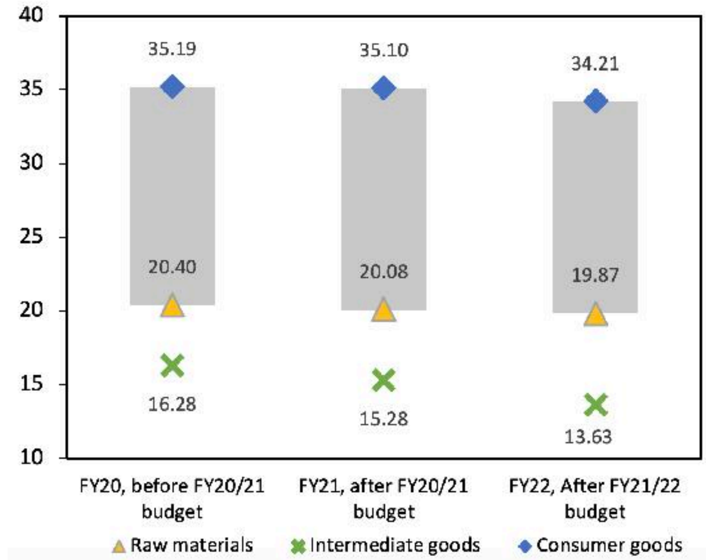
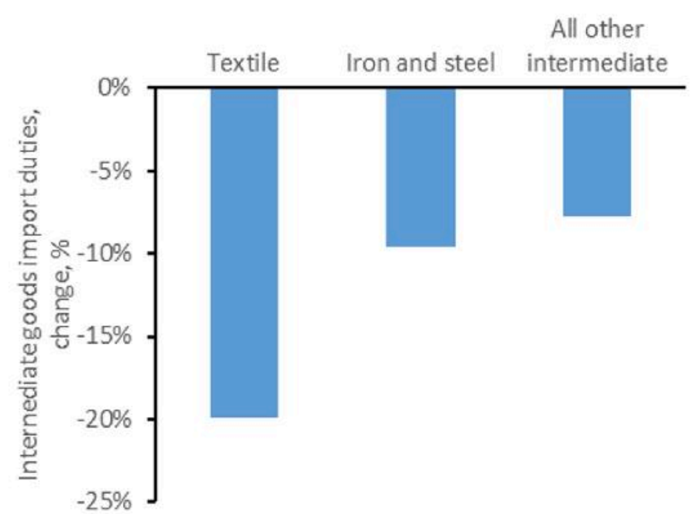


Figure 3: The disproportionate reductions in import duties on intermediates for established sectors show the anti-new bias of tariff policy



Source: Authors' elaboration based on FBR and WITS

Conclusion:

Placing productivity at the forefront of Pakistan's growth agenda requires bold reforms to incentivize technology adoption while gradually increasing competition in the market. Tariff policy can be a useful instrument to those ends, if reforms focused both on reducing duties on intermediates and on final goods: that way, the anti-export bias of tariff policy would gradually fall. The reforms in this budget, however, are too timid in this respect.