Bangladesh Policy Notes

Modernizing Tariff Policy

Key issues and challenges

Tariff modernization will help Bangladesh diversify its export basket. Tariff modernization is at the crux of input competitiveness for efficient manufacturing given that more than 90 percent of the raw material for exportable goods are imported in Bangladesh and the other export incentives like bonded warehouse facilities are not accessible to firms other than Ready Made Garments and a few deemed exporters. Duty drawback system is also designed to discourage traders from claiming it in the first place and cash incentives can only be used as a temporary measure.

Tariffs serve a dual purpose of revenue-generation and protection. Efficient collection of import tax affects revenue mobilization, trade facilitation and overall economic performance. If set correctly, tariffs play a dual role of generating revenue from imports and providing protection for domestic industries. However, beyond a certain tipping point, tariffs adversely impact revenue generation. In an era of progressive trade liberalization, finding that balance is a challenge because all direct and indirect taxes are expected to be designed in a way that ensures maximum revenue mobilization.

Bangladesh has made significant progress in tariff modernization, but there is room for improvement. The economy of Bangladesh has become increasingly open since independence in 1971. Trade liberalization has been stepped up since 1990, which has opened opportunities for regional trade integration. However, there have been periodic reversals. Policy reform included a substantial scaling down and rationalization of tariffs, removal of trade-related Quantitative Restrictions (QR), elimination of import licensing, unification of exchange rates, and the move to a managed float exchange rate regime. The tariff structure has been simplified by moving from 22 tariff slabs in FY1992 to only five non-zero slabs: 1, 3, 5, 10 and 25 percent in FY2016. In addition, a 15 percent slab was introduced in FY2017. Although the average customs duty has come down over the past 15 years, the average Nominal Protection Rate (NPR) shows a mixed trend. A downward trend until FY2009 has since been reversed. Revenue or protectionist considerations have historically dominated trade policy issues. Trade policy has thus been skewed, and there has not been a strategy deliberately intended to benefit consumers and export sectors other than garments. Despite the tariff reductions over the last 25 years, average tariffs in Bangladesh (at 25.6 percent) are still higher than in comparator countries and regions (China 9.7 percent, India 12.1 percent, South Asia 12.2 percent).

There is a significant divergence between the top NPR, which has moved up since FY2001, and the average NPR. Disregarding the high rates on luxury goods, such as automobiles, alcoholic beverages and tobacco, the top general NPR was 85.6 percent in FY2017, which is significantly higher than the average NPR of 22.95 percent. This was because a select group of domestically produced import substitutes (like ceramics, footwear and agro-processed products) were given tariff protection well above the average.

There has been a proliferation and rise of the para-tariffs. The most notable development since FY2001 is the rise and proliferation of para-tariffs, such as supplementary duty (SD) and regulatory duty (RD). They were mostly applied on products subject to the top Customs Duty (CD) rate of 25 percent, which raised the nominal protection of the relevant tariff lines. In FY2017 SDs and RDs contributed nearly 50 percent of the value of the average NPR. The rise in para-tariffs appears to have offset the decline in average CD rates. In particular, SD, which was applied under the VAT and Supplementary Duties Act 1991, was not applied on a trade neutral basis (equally on imports and domestic production as the law required) but was applied mainly on imports, thus becoming a major instrument of protection.

There is significant tariff escalation at the last stage of processing. The CD tariff slabs were designed to levy higher duties on final consumer goods (25 percent), and lower duties on inputs (intermediates at 10 percent, basic raw materials at 5 percent, capital goods at 1-2 percent). The huge escalation of tariffs between input and output was clearly meant to impart a high degree of protection to domestically produced consumer goods.

There has been a growing divergence between input and output tariffs over time. Since 2009, the divergence between input and output tariffs got wider. This resulted in a sustained level of high effective protection to many sectors. Just as with nominal tariffs, the fact that effective rates of protection in Bangladesh are significantly higher than in comparator countries is shown by the comparison of tariff escalation ratios (ratio of output to input tariffs). The upward trend in the tariff escalation ratio during FY2000-FY2014 demonstrates the rising trend in effective protection rates, which only declined moderately after FY2014. These high and rising rates of effective protection to import substitute production reveals an imbalance of incentives in favor of import substitutes over exports – a clear case of anti-export bias of incentives.

High Effective Rates of Protection (ERPs) indicate latent inefficiency in the firms. At the firm level, there were very high ERPs for most import substitute consumer products receiving tariff protection. In 2012, ERP estimates for footwear, agro-based industry, pharmaceuticals, ceramics, plastic products, light engineering, sanitary and electrical products, ranged from a low of 20 percent for pharma to a high of 480 percent for plastics. High ERPs typically indicate latent inefficiencies in firms, which tend to perpetuate over time.

Trade protection measures from FY2013-17 are estimated to have cost Bangladesh's consumers $70.6 billion. Trade protection through tariffs not only reduces the competitiveness of domestic firms, but studies show it also impacts consumer welfare. Based on the estimated cost of protection measures related to consumer goods imports and the domestic production and sale of import substitute consumer goods, in the 5-year period FY2013-2017 the total protection cost to consumers was $70.6 billion.

Policy Recommendations

To address these issues, in the short term, the government needs to:

- Assess the impact of the current tariff structure on raw material which have export potential. This will enable a common assessment of the issue.
- Review the dispersion within the same Harmonized Commodity Description and Coding System – (HS) Codes –to prevent misdeclarations and flaws in assessments.
- Develop a strategic roadmap for tariff modernization with a gradual reduction in protection to encourage export competitiveness and integration.

To address these issues, in the medium to long term, the government needs to:

- Develop the capacity of the National Board of Revenue and Ministry of Commerce for policy and data analysis using available statistical tools and software.
- Based on assessment reports, select sectors with export potential and identify the scope for tariff rationalization for the competitive sourcing of inputs. Accordingly, draft and implement a sector-based roadmap for tariff modernization.
- Reduce the budget's dependence on trade tariffs.