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Customs Tariff Reform

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Preface

ICRIER research is disseminated in the form of seminars, working papers and other publications. By its nature high quality research must meet academic standards of thoroughness. This sometimes makes it too long and difficult for the general educated reader who is interested in the essential ideas and policy implications without necessarily requiring the same degree of documentation as the academic community. We need to reach a wider circle of opinion makers who perhaps do not have the time to delve too deeply into the intricacies of each topic but are interested in and would benefit from research based policy advise. It is therefore necessary to simplify and shorten the presentation. The series of Policy Briefs is our attempt to bring to a wider audience a discussion of policy issues based on relevant research findings.

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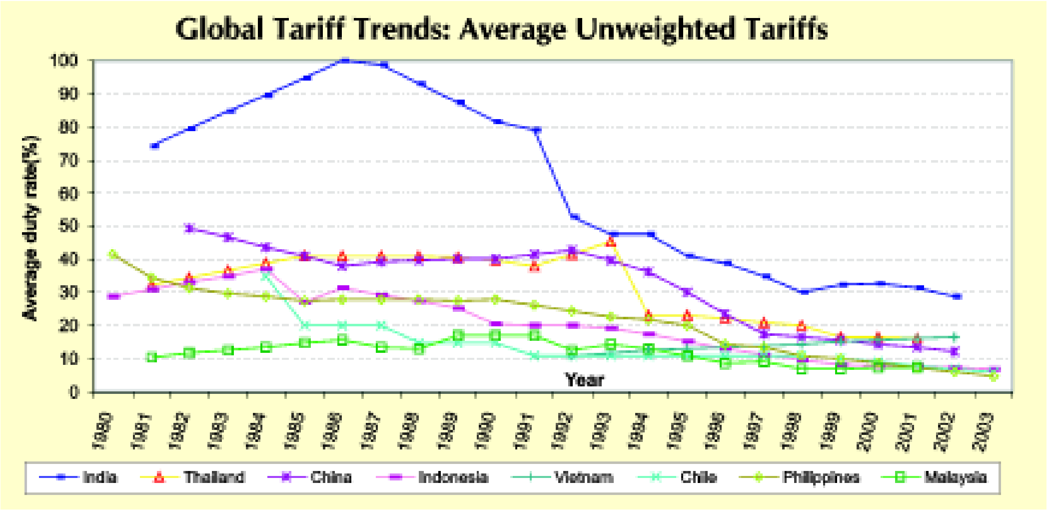
Customs tariffs in India have come down significantly over the last decade. The 'peak' customs duty rate for instance has progressively come down from around 150% in 1991 to 20% in 2004. Similar is the case with average tariff levels (figure). Yet the tariff rates in India remain among the highest in the world.[1] Out of a set of 122 countries for which data on (simple) average un-weighted customs tariffs was available for any year from 1996 onwards, India was the fifth highest average tariff (i.e. it ranked 118th).[2] Only Cambodia (35%), Bahamas(32%), Burkina Faso(31.1%) and Tunisia (29.9%) had higher average tariffs than India. Emerging market economies like Czech republic (5%), S. Africa (5.8%), Chile (6%), Russia (9.9%), Turkey (10%), Venezuela (12.4%), Argentina (12.7%), Poland (13.4%) Mexico (18%) and Egypt (19.9%) had average rates ranging from 1/6th to 2/3rd of India's 29.%.



Reduction in the high rate of customs tariffs has been an essential element of the tax reform policy followed since 1992.[3] This policy has had the predicted effect of putting competitive pressure on industry as evidenced in the range and quality of consumer goods, particularly consumer durable goods (e.g. cars, motorcycles, TVs, household appliances) produced in the country.[4] Allocation efficiency has also increased, as reflected in the increase in intra-industry trade and the increase in net exports.[5] Except for the temporary reversal for a few years in the late nineties, the strategy for achieving the objective of tariff reduction and rationalisation has remained broadly unchanged. The basic strategy has been to,

(a) Progressively lower the "peak" customs duty rate,

(b) Raise the rates on exempted items whenever possible, thus reducing the dispersion of rates over time,

(c) Refrain from raising any individual customs duty rates to the extent possible, thus reducing the effective protection on the most highly protected items, and

(d) Make tactical/temporary concessions on selected goods by raising duty on specified goods above the so-called "peak" rate,[6]

The speed of 'peak' tariff rate reduction has been moderated by the need to avoid absolute reduction in tariff revenues and to give time for alternative revenue sources to fructify.[7]

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[1] See Virmani 2001 for detailed analysis of data up to 1999.

[2] The data set is compiled by WTO, based on information from member countries, WDI, World Bank and other sources.

[3] These reductions were completely unconnected with and independent of the WTO, in contrast to the elimination of QRs on consumer goods in the mid-nineties.

[4] This can be seen across all price ranges, not just in the so-called luxury categories.

[5] See for instance Veeramani (2004), Virmani et al (2004).

[6] These four elements together have minimised the damage arising from political and other pressures.

[7] Not surprisingly vested interests with clout have also sometimes upset this pragmatic approach in the past, by getting the tariff rate on their output raised or the tariff rates on specific inputs used by them reduced. Such increases in effective protection, which provide a greater cushion for inefficiency, have invariably been passed off as being in the national interest even though they clearly harm all user industries.

The final target for tariff reforms has never been clearly spelt out, though the Tax reform committee (1992, 1993) proposed a multi-tier structure with a 'peak' rate of 50%.[8] The multi-tier structure was close to a four-tier one, which distinguished raw materials, intermediates, capital goods and 'in-essential' consumer goods.[9] In the mid-nineties the three-tier structure attained greater currency and was occasionally proposed by industry associations. The three tiers proposed by them consisted of (i) Raw materials, (ii) Intermediates and (iii) final goods (both consumer and capital goods). Contrary to this prescription, tariff reforms during this period reduced import tariffs on capital goods much faster than on many raw material & intermediates that are used in the production of capital goods, with a view to reducing the cost of investment. Similarly tariff rates on agricultural raw materials were relatively high, rather than being the lowest as proposed in the 3-tier structure. Once the peak rate was reduced to 50%, two possibilities emerged more explicitly in the public debate: a three-tier and a two-tier structure of tariffs.

The 'peak' rate was reduced to 20% in the 2004-5 interim budget as per the commitment made in the previous two budgets (part I of finance minister's speeches).[10] The report of the 'Inter-ministerial group on customs duty reform' submitted in November 2001, had argued that reform of the import duty structure within the existing commitment to bring the peak duty rate to 20% creates certain constraints on rationalisation of the entire structure and elimination of anomalies (inverted duty structure and dis-protection) by 2004-5.[11] It therefore felt it necessary to look at the evolution of import duties beyond this date and recommended achievement of a near uniform tariff rate by 2006-7.[12]

The budget of 2002-3, however, implicitly rejected the suggestion for a uniform customs tariff rate by adopting the two-tier structure that had begun to be favoured by some industry groups during the late nineties. It proposed that final goods have a duty rate of 20% and intermediate goods 10%.[13] In what follows, we outline the flaws inherent in a two-tier structure and the disadvantages arising from the relatively high rates. The PM and FM's intention of bringing India's customs tariff rates to East Asian levels (supported by all finance ministers during the nineties), now requires the setting of clear targets. The note argues that tariff rates be brought down to globally competitive levels and proposes a uniform structure of tariffs. The advantages of such a structure are enumerated and a phased program to achieve this target is suggested.

The two-tier structure recommended by the Kelkar Task Force (KTF) has many flaws. The most important economic distortions are, (a) That the effective protection for "final" goods can vary between 21% and 210 % (industries such as spinning and refineries would lie at the upper end), and (b) That within the category of final goods the effective protection varies inversely with the value added by the producer of the final good. Contrary to popular perception, such a structure of tariffs will give the least incentive to those producers of final goods who add the greatest value. It will make life easiest for the least efficient, most capital intensive and energy intensive producers by giving them the greatest protection.

Another major flaw in the tariff structure proposed by KTF is that it does not achieve much reduction relative to our comparator countries. In this globalised era, export oriented FDI depends on a country's tariff levels relative to that of competing countries, particularly those in East and South East Asia.[14] In addition to this indirect effect on exports, relatively high tariffs create problems of import diversion and smuggling through neighbouring

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[8] Chairman Dr R J Cheliah..

[9] The interim report in fact endorsed the recommendations of the paper on Long Term Fiscal Policy on this matter.

[10] There is however no move to lower the above 'peak' rates applicable to automobiles and agricultural goods. The 'Task Force' has endorsed the existing system of above peak rates as high as 150%.

[11] The 'Virmani Committee' referred to in the Task Force on Indirect taxes' Consultation paper and in the Report (December 2002). Though the analysis of this report was put on the web, its (detailed) recommendations were never released to the public.

[12] A phased reduction of most rates to 10% by 2006-7 and a phased elimination of exemptions over the same period.

[13] The consultation paper on indirect taxes (chairman Dr. Vijay Kelkar) supported this approach by reiterating that raw materials, inputs and intermediate goods should have a rate of 10% while final goods should have a tariff rate of 20%. The final report (December 2002), however takes another step backwards by recommending a four-tier structure for 2006-7.

[14] After Cambodia, Vietnam had the highest average tariff of 16.4%, followed by Thailand (16.1%), S. Korea (11.6%), Taiwan (7.8%), Malaysia (7.3%), Indonesia (6.9%), Philippines (4.7%), and Singapore & Hong Kong (0%).

countries.[15] The fact that India has some form of free trade arrangement with several of its neighbours (e.g. Indo-Nepal & Indo-Sri Lankan agreements) means that it becomes profitable to import many items into these countries and then re-export them to India. Any objective assessment would suggest that Indian industry can surely compete with industry in these countries (Nepal & Bangladesh belong to the set of least developed countries) and there can be no rationale for an average rate higher than that of mountainous, landlocked Nepal.

Even with our peak rate brought down to 20% in 2004-5, we will still have some way to go to reach the tariff levels of East Asia as they stand today.[16] Most ASEAN rates are to be reduced to the 0%-5% under the ASEAN free trade agreement (AFTA). This will reduce the average rates of Thailand, Indonesia and Malaysia even further below ours. Similarly China has made commitments to reduce tariff rates over the next 3 to 5 years. The average tariff rate of the developed countries is around 3.8%.[17] Capital inflows have accelerated over the last two years putting greater pressure on the rupee to appreciate. It is therefore imperative, to go beyond the existing commitments, and bring peak rates to E. Asian levels in the next five years and to developed-country, internationally competitive rates of customs duty protection by the end of the current decade. This will give sufficient time for industry and agriculture to adjust to these changes, and for government to ensure that domestic control and bureaucratic constraints are eliminated.

The final flaw in the earlier approach was that the basic rate of duty on many agricultural goods and on automobiles is currently higher than the "peak" rate of 20% and ranges up to 100% for agricultural goods and 150% ('maximum above-peak' rate) for alcohol preparations as proposed by the Task Force on Indirect Taxes.

Customs duty reforms can be carried out in two phases. In phase I, ending in 2006-7, a 'near uniform' basic customs duty rate of 10% should be achieved. In phase II, this should be reduced to a single basic customs duty rate of 5% [Virmani (2002)]. The other components of phase I are,

(a) The "peak' duty to be reduced to 15% in 2005-6 and to 10% in 2006-7.

(b) Elimination of most end-use exemptions as well as all temporary exemptions, so that the 10% becomes the standard rate.[18] At this point all anomalies would be removed with the exception of those arising from international agreements.[19]

(c) It is difficult to bring the exceptionally high 'above peak rates' down to 10% in 2006-7 given the slow pace of agricultural diversification. The above-peak rate exceptions should be specified as a multiple of the peak rate and not fixed in absolute terms, as is done presently. Most of these should be set at two times the 'peak' rate (i.e. 20% in 2006-7) while the 'maximum above peak rate' would be three times the 'peak' rate (i.e. 30% in 2006-7). Such exceptions should remain limited in number (not more than one-tenth of the tariff lines).

If one looks only at the explicit tariff rates when thinking of the degree of protection, one is likely to be misled into concluding that overall protection will fall drastically. This is not true. The exchange rate also influences protection and can be viewed (in laymen terms) as providing additional protection to that provided by tariffs. The nominal protection available to Indian producers of tradable goods (as a whole) is a combination of the exchange rate of the Indian rupee and the weighted, average tariff-rate. At any point in time, different combinations of average customs tariffs and exchange rate can give the same level of protection. For any given protection level, combinations with high customs duty rates, however, reduce the competitiveness of the Indian economy. These combinations are inefficient as they bias the overall economic system against exports. This is because a depreciated exchange rate (at the prevailing domestic prices) gives equal incentive to exports and import substitution, while a higher tariff gives a greater incentive for import substitution vis-à-vis exports.

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[15] All our South Asian neighbours such as Sri Lanka (8.2%), Pakistan 17.1%, Nepal (17.7%), Bangladesh (19.5%) and as well as our northern neighbour China (12.4%) had lower average tariffs than we did.

[16] See footnote 14.

[17] Japan is at 3.3%, New Zealand 3.8%, USA 3.9%, Australia 4.1%, Canada 4.2% and EU 4.4%. Switzerland (0%) and Norway (2.5%) have lower average rates.

[18] 9/10th of importable goods would then be subject to this 'standard rate'.

[19] The reduction of the "peak" rate to a reasonable level makes it easier to eliminate most exemptions. The minimum duty on exempt items earlier subject to a 5% duty would be raised to 10% in 2005-6 or 2006-7.

A single uniform rate of basic (protective) customs duty on all imports has many attractive features.

a. *Efficient*: With a single, uniform nominal duty the effective protection rate is also identically equal to this rate. The rate of effective protection is therefore neutral and equal for all value added by domestic producers. This will increase the efficiency and competitiveness of the entire economy compared to the alternative system.

b. *Equitable*: Uniform effective protection on all producer goods is more equitable in that it removes the discrimination against other producers. Higher protection for one set of producers inevitably results in lower protection for some other producer. Such a regime will eliminate special interest lobbying, the special benefits to large industry & powerful interest groups and losses to the small and unorganised.

c. *Simpler*: With nominal protection for all imports identical, all classification problems and disputes will be eliminated, resulting in substantial saving in administrative and legal costs. As a single rate applies to all imports only a total value of imports needs to be specified in any advance license, making actual import 100% flexible. Similarly any draw back or refund calculation only needs the total value of imports used in export production.

d. *Administratively easier*: It will be much easier to administer the duty-free import regime for exporters. Most imports can in principle be on self-declaration basis and customs staff can focus their time and energy on checking smuggling (through mis-declaration of quantity or concealment of item) and chronic misstatement of price. With the uniform rate reasonably low the incentive for smuggling will be minimised and customs revenue would be improved as more imports come in through the legal route. This would also make the administrative problem of checking smuggling, manageable.

e. *Regionally competitive*: A low uniform rate duty will have the additional benefit of reducing our weighted, average tariff rates below those prevailing in neighbouring countries. Our economic interests will then become much more closely aligned with theirs. Indian industry and agriculture will have much less to fear from FTAs with our neighbours in West, South and S. East Asia than is the case today. A low uniform duty that is close to the average for ASEAN countries will also enhance the benefits to India from the Indo-ASEAN FTA that will be substantially (fully) implemented by 2006-7 (2011).

The market oriented external trade regime can handle internal and external shocks much better, so that there is a strong argument for reducing the tariff rates to international levels by the end of the decade. This has been demonstrated by our own experience of reforms since the 1990-91 BOP crisis, with the opening of the economy to international trade and capital flows greatly strengthening the external account. We therefore propose further reduction in tariff rates during Phase II (i.e. from 2007-8 onwards). In this phase tariff rates should be brought down to OECD levels from the (current ASEAN) levels projected for 2006-7 (table). The ASEAN Free trade Area Agreement and the CEPT programme will bring ASEAN rates to the 0% to 5% range by 2010, even for "highly sensitive" agricultural goods & "sensitive" products (mainly agricultural) and even for the recent entrants like Cambodia & Laos. Our protective duty rates (and the VAT system) will then be competitive with those prevailing in developed and emerging market economies.

During the second phase the "peak" rate would be reduced from 10% to 5% and the "maximum above-peak" rate also brought down to the "peak" rate of 5%. The import duty on above peak rate exception items would be reduced gradually to 10% by 2008-9 (or 2010-11) in annual reductions of 5% points (see table below). Thus by 2011-2 there should be a single, uniform, basic custom duty rate of 5% on all goods.

The proposed reduction of duties will be accompanied by a real depreciation of the rupee relative to the exchange rate in the base line scenario (of no tariff reductions). This will substantially off-set the direct effect of tariff reduction on industrial goods. The easy availability of inputs at low tariff rates and the pressure to improve productivity should take care of the remaining gap. No significant industrial product line is likely to go out of business, though intra-industry trade will increase even more rapidly [Virmani et al (2004)]. The proposed tariff reduction and rationalisation will result in a quantum jump in export competitiveness and globally competitive (export oriented) FDI in the manufacturing sector [Banga(2003)]. The export of labour intensive manufactures will increase and result in substantial increase in employment opportunities for the less educated. If accompanied by an elimination of SSI reservation and reforms to increase labour flexibility it could make India into a genuine competitor to China for the title of the, 'world's workshop.'

Table: Customs Duty Reform Targets

	Description of Goods	Existing 2004-5	Proposed 2005-6	2006-7	2007-8	2008-9	2010-11
1	All Goods (excl 2-8)#	20%	15%	10%	7.5%	5%	
2	Cars & 2-wheelers*	60%	30%	20%	15%	10%	5%
3	Agricultural						
	General	30%-60%	30%	20%	15%	10%	5%
	Specified*	65-100%	45%	30%	25%	15%	10%
4	Hard Liquor (> 5% alcohol)	150%	100%	50%	25%	20%	15%
	Exemptions International Agreements						
5	15 specified goods	0%					@
6	4 specified goods	3%					@
7	4 specified goods	5%					5%
	Administrative/Valuation						
8	Specified goods (~20)	0%					0%
	National VAT (AD)						15%

Note: # this is the so called "Peak Rate"
* Agriculture & allied goods include agro based products like wine & beer (low alcoholic beverages with alcohol content $\leq$ 5%)
@ International agreements should be modified to allow 5% tariff. [If this is not done exempt (0%) goods are likely to increase]

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