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When imports matter for exports

Firm level evidence from Pakistan



In brief:

- This study by Dr. Salamat Ali, Dr Mohammad A. Razzaque, and Shafqat Ali Khan investigated the linkages between liberalisation of imports and diversification of exports by using detailed firm-level data on imports, exports, and production for Pakistan.
- The study used administrative dataset of exports, imports, and domestic sales for the period 2000-2016. The import and export data contained 27.8 million and 16.2 million transactions respectively.
- The study finds strong evidence of cointegration between imports and exports, suggesting a long-run relationship between these two series. The relationship holds at the macro, sectoral, and firm levels.
- The findings also suggest that additional levies apart from just customs duty can have major trade-impeding effects. Therefore, policymakers aiming to promote exports of domestic firms need to realise that the entire set of border taxes that contribute towards input and output costs are key constraints on export growth.

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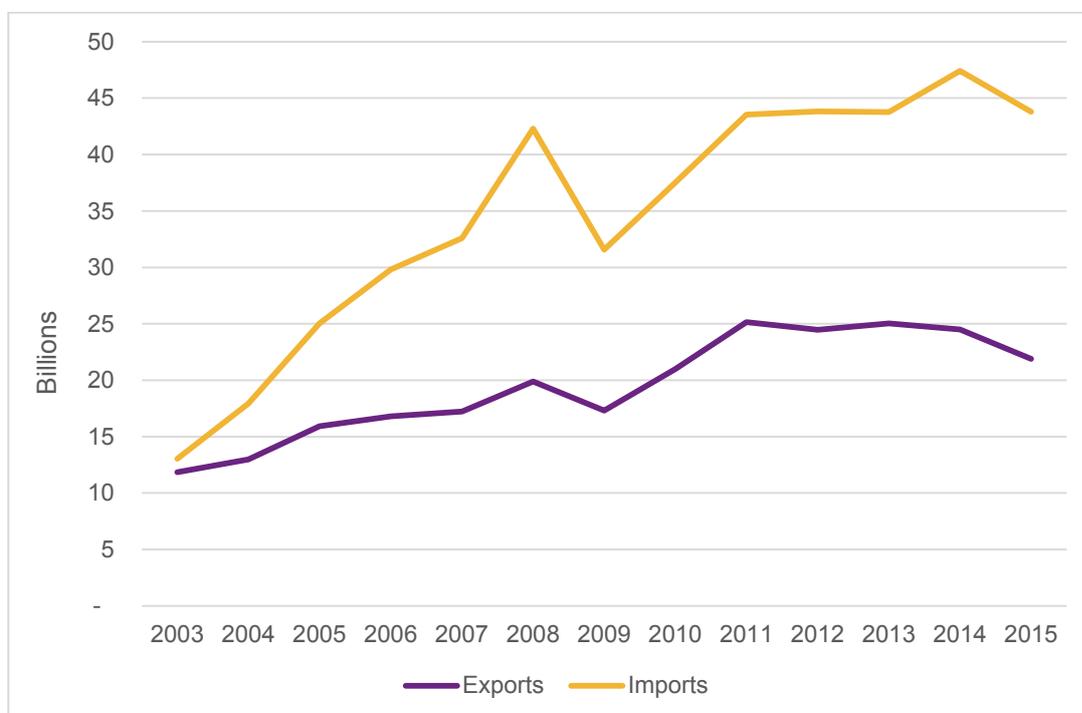
Overview of the research

During the recent wave of trade liberalisation, started in 1995, import tariffs in most developed and developing countries were brought down to a historically low level, but Pakistan continued to maintain high effective rates of protection¹ across a wide range of sectors. According to UNESCAP (2015), the effective rate of tariffs in Pakistan was 14.3% against the corresponding Asia-Pacific average of 7.4%. Similarly, Pakistan's World Trade Organization (WTO) bound duty rate is 60.2%, which is almost three times the Asia-Pacific average of 21.7%. High import taxes not only raise the prices of consumer goods but also increase manufacturing costs of exports given that many imported inputs are also used as industrial raw materials. This rise in production costs could make a country's exports uncompetitive in international markets and pose a major constraint to prospects for export growth and diversification.

In recent years import tariffs in Pakistan have been slashed gradually. A major decline came in 2004-05 when sales tax (at 16%) levied on imports was abolished for industrial inputs and the output tariffs on final goods was also slashed. However, subsequent governments have since substituted this reduction in customs duties with other import levies, as a result of which Pakistan's effective tariff on imports hovers at around 33%.

Pakistan's exports grew from \$12 billion in 2003 to \$23 billion in 2015 (+85%), and its imports surged from \$13 billion to \$54 billion (+335%). The relatively slow growth in exports in this period questions the effectiveness of the substitution policy, especially at a time when the country's exports have stagnated around \$20-25 billion since 2011. This can be seen in Figure 1 below.

Figure 1: Pakistan's Overall Trade Flows, 2003-2015



Source: Authors working using data from World integrated Trade Solutions (WITS).

¹ Both in terms of trade-weighted average as well as effective rate of protection.

In this background, the study aimed to understand the effects of tariff cuts Pakistan has undertaken on several dimensions of export growth, and as such, inform policymakers about export potential that can be materialised by rationalising these tariffs further. In particular, it examines:

- (i) The cointegration between imports and exports at macro, sectoral, and firm-levels;
- (ii) Effect of tariff cuts on diversification of imports and exports,
- (iii) Entry into exporting,
- (iv) Export intensity of existing exporters,
- (v) Potential export gains due to further tariff cuts, and
- (vi) The cost of further tariff rationalisation to the government exchequer.

Snapshot from Pakistan's data

Data indicates that a small fraction of exporting-cum-importing firms handle a bulk of national exports (Table 1). Although, they constitute around 32% of exporters, their contribution to overall export volume is around 81%. This concentration of large export volume in the two-way traders alludes to the existence of importers' premia and highlights the significance of facilitating imports as an engine of export growth so as to improve competitiveness of these firms.

Table 1: Trade share by trade orientation, 2015

Trade orientation	Firms		Exports (PKR, Bn)	
	Number	Percent	Value	Percent
Exporting-only	11,793	68%	478	19%
Exporter-cum-Importers	5,466	32%	2,094	81%
Importing only	20,351			

Source: Authors' calculations with customs data.

Findings

- The study shows that at all three levels – macro, sectoral, and firm-level – imports and exports are co-integrated and move in the same direction. This, in turn, confirms the role that import competition and imported raw materials have in promoting exports.
- Tariff cuts lead to firms increasing their overall imports, widening the set of imported products, increasing sources of imports (i.e., their origin) and also procuring from a wider set of products from existing sources. However, it is important to note two observations. First, the effect is larger for consumer and intermediary products than for capital goods and raw materials. Second, the impact is much larger for all border taxes than for changes in customs duty alone.
- Diversification of imports is associated with the diversification of exports: firms that import large number of varieties also export more varieties of products; firms that source from many markets are able to export to many markets; and firms that diversify their suppliers' network are able to sell to a large number of buyers in foreign markets.

- The exporting-only cohort is more dynamic in nature: their entry and exit rates are larger than that for firms catering to domestic plus international markets. Second, the fraction of entrants is gradually declining. A large fraction of entrants' cease exporting each year, but the exit rate is declining over time. Export contribution of entrants is relatively limited. These firms constitute around two-thirds of exporters but handle less than 5% of total exports, with this proportion declining over time.
- A 10% reduction in tariffs is associated with an increase in export intensity by 0.13. This relatively large trade effect indicates that exporting firms face stiff competition in the home market from imports after tariff reductions.
- Firms also increase the exports of peripheral products that are produced by other firms. However, the increase in manufactured products drives overall increase in export growth.
- A reduction of 10% in import tariffs could increase Pakistan's imports by 4.18%, from \$47.5 billion to \$49.5 billion. The increase in import volume would partially offset the loss of tariff revenues. Therefore, the loss to the government exchequer would be relatively modest. Overall, the study expects the revenues associated with customs duty to drop by 6.37%, from \$2.96 billion (actually collected in 2016) to \$2.77 billion.

This study sheds light on the effectiveness of using tariff rationalisation as a policy tool for promoting exports through the channels of reduced cost of imported intermediary inputs and fostering competition in the domestic market. While most existing studies in this stream focus only on one channel, this work deviates from the existing literature by investigating the effects emanating from both channels along multiple dimensions of export performance. The study also finds that the trade-inhibiting effect of other border taxes (income tax, sales tax, and provincial levies), which are mainly ignored in the literature, is quite large. The additional levies raise the overall trade-restricting effect of tariffs many folds. However, the gains associated with liberalisation are much larger.

Policy recommendations

Trade is one the growth engines which remains significantly under-exploited in Pakistan. Bringing import tariffs down can influence the export behaviour of firms through multiple channels. The reduction in the cost of imported inputs may incentivise firms to diversify their imported input sources (variety effect) or procure higher quality inputs at relatively lower prices (price effect). This access to new input varieties may contribute to raising the quality of existing products (quality effect), exporting to new markets (diversification), adjusting export product mix (product churning), as well as expanding customers' base in existing markets (export penetration). Similarly, it may stimulate technological and product innovation. Moreover, the increase in imports due to reduction in tariffs on final goods may push firms to increase their exports of existing products to compensate for the shrinkage of their domestic market share (competition effect). This increased product market competition can help firms reduce their x-inefficiencies and increase productivity.