

FIX INVERTED TARIFF STRUCTURES TO BOOST INDUSTRIAL GROWTH IN INDIA

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Foreign Capital, Foreign Trade & BOP

Correcting import-duty anomalies will attract foreign firms to set up assembly bases here and lift our global competitiveness

A steady decline in import tariff rates in manufacturing industries had been an important feature of India's economic reforms during the 1990s and 2000s. The average import tariff rate was reduced from about 84% in 1990 to the lowest-ever level of 8.6% in 2010. Consequently, imports of goods plus services as a percentage of India's [gross domestic product](#) (GDP), which is essentially a measure of import openness, steadily increased from 8.5% in 1991 to 30.6% in 2012. The period since 2010, however, witnessed a gradual increase in import tariff rates.

A well known result in economics, referred to as the Lerner Symmetry Theorem, states that import tariffs generally act as a tax on exports. In other words, a tariff on imports disincentivizes exports, just the way a direct tax on exports does. Indeed, exports of goods and services as a percentage of India's GDP decreased from a peak of 25% in 2012 to 18.6% in 2019. This is a clear reversal of the trends observed during the first two decades of economic reforms. It is important to note that the decline of India's export openness since 2012 was not a compulsion imposed by conditions prevailing in the rest of the world; the ratio of world trade to GDP remained unchanged at around 30% after 2012. During 2000-2011, India's exports recorded high annual growth rates of 21% and 24%, respectively, for goods and services. However, exports of goods completely stagnated—with an annual growth rate of almost 0%—during 2012-2019, while the growth rate of services exports declined to 5.9%. The latest available data shows that exports of goods and services declined by 15.7% and 8.1%, respectively, during April-December 2020. For imports, the pace of decline was faster, with falls of 29.1% and 14%, respectively, for goods and services.

A study by the Exim Bank of India showed that the total number of direct and indirect jobs tied to India's exports increased from about 34 million in 1999-00 to 62.6 million in 2012-13. A related study done at the Indira Gandhi Institute of Development Research showed that this number declined to 58.1 million in 2017-18. Clearly, restoration of export growth to its level during the 2000s is needed to bring the economy back on track.

What type of policy interventions would help achieve faster export growth? Last year's Economic Survey articulated that India could reap rich dividends, in terms of value addition and job creation, if the country were to follow the Chinese model of export-led growth, with active participation in global value chains (GVCs). In particular, the survey identified huge unexploited potential in a group of manufactured products known as 'network products', so named due to their highly fragmented nature of production across countries. Examples of network products include electrical machinery, electronic equipment, road vehicles, office machinery, telecommunications equipment, etc. China has benefited from the scale and productivity effects that arise from specialization in the labour-intensive 'assembly' segment of GVCs across network products. China saw a huge surge in its imports of parts and components, which were then assembled in its factories for final products to be exported to the world market. World exports of network products amounted to \$5.6 trillion in 2018, of which India's share was a paltry 0.5% (\$27 billion) compared to China's 17.5% (\$981 billion).

With the current global backlash against China and its rising wage rates, this is an opportune moment for India to put effort into becoming an assembly hub for the world. India will, however, miss this opportunity if protectionist policies are adopted. Instead of closing its borders, the country should reduce customs duties to provide easy access to imported inputs. If tariff rates are high, particularly for intermediate inputs, global companies will be reluctant to choose India as their preferred location for final assembly. Further, high input tariffs imply a rise in costs for domestic manufacturers, which would defeat the objectives of the 'Make in India' initiative. The Union budgets for the last two years saw an increase of import tariff rates for a range of parts used in network product industries. For instance, the duty on display panels and touch assemblies used in mobile phones has increased from 0% to 10% , on catalytic converters from 10% to 15%, stainless steel products from 5% to 7.5% and sound signalling equipment for two-wheelers from 7.5% to 15%.

The forthcoming budget should begin the process of cutting India's high import tariff rates. Further, the issue of tariff inversion needs to be addressed. An inverted duty structure is said to exist when the duty rate for the overall finished good is lower than that of the component parts, thereby rendering such a product's final manufacture in the country uncompetitive. Duty inversions hinder India's chances of undertaking large-scale assembly activities in network products. The tariff inversion for a given industry may be defined as the ratio of average tariffs for all inputs used by the industry to the average tariff for the industry's final output. The particular industry's tariff structure is said to be inverted if this ratio is greater than 1.

Our estimates confirm that this is indeed the case for most of India's network product industries. This is not the case in China, where input tariffs are found to be lower than output tariffs. This problem is found to be the most serious for such industries as electronic components, consumer electronics, magnetic and optical media and computer and peripheral equipment. It may be noted that as part of the [World Trade Organization's](#) Information Technology (IT) Agreement, India has brought down its import tariffs on electronics and IT products even as tariffs on intermediate inputs used in these industries remain high. Until 2018, the tariff structure was not inverted in the manufacture of transport equipment, an industry that has recorded relatively better export performance in the recent past. But, this is no longer the case due to the recent tariff increases for the inputs used in this industry.

While inverted tariff structures act as disincentives for global companies to set up their assembly units in India, they also put Indian manufacturers at a disadvantage vis-a-vis their foreign competitors. The forthcoming Union Budget for 2021-22 offers an opportunity to address these distortions.

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