



PAHLE INDIA FOUNDATION  
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DISCUSSION PAPER

# In Defence of Pragmatic Protection

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PIF/2019/TIDE/DP/14

By  
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# In Defence of Pragmatic Protection

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## **Background**

Budget 2018-19 increased customs duty in quite a few sectors to provide adequate protection to domestic industry. An increase in tariff was effected in the case of a few sub-sectors of food processing, perfumes and toilet preparations, automobile and automobile parts, textiles, footwear, diamonds, precious stones and jewellery, electronics/hardware, furniture, watches and clocks, toys and games, and other miscellaneous items. Policymakers have made it clear that this is a temporary window of opportunity given to these sub-sectors to firm up their performance. Despite this, many respected commentators see increased tariffs as a change in policy stance from an open economy to a more restricted economy and have been quick to point out the potholes in this direction. Others argue that most of the gains from trade accrued when developed economies were more open than they are now. This argument, however persuasive, does not take into account that in such an insular world, imports tend to become even cheaper, increasing the real income of the poor. Given India's gigantic market size, all exporting countries desperately need access to the Indian market. However, it must also be mentioned that given India's huge addition to labour force every year, fragmented land holdings, and low productivity in agriculture, the government is in search of sectors where the swelling labour force can be absorbed. Thus, policy has the unenviable task of striking a balance between keeping inflation down to manageable levels and the generation and conservation of jobs.

In this paper, we first provide evidence to show how imports have affected domestic prices and to show that domestic protection to sectors has not necessarily translated into a competitive economy. We then pick up the silk fabric sector that was given protection in Budget 2018-19 and try to find evidence if such a policy was necessary.

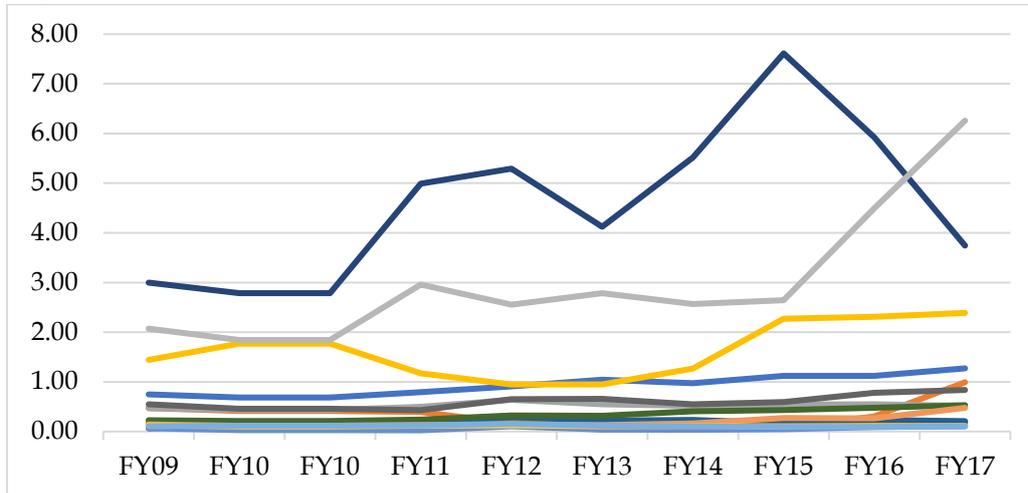
## **Imports and Price level**

As per the 18<sup>th</sup> Global Trade Alert report (Evenett& Fritz 2015), from November 2008 until October 2015, the total number of trade discriminatory measures implemented by India was 504, the highest among the G20 nations. Economic literature is clear that although the aim of protectionism is to improve industrial efficiency and competitiveness, this comes at a substantial cost. By supplying products at lower prices, trade increases the gains of the poor more through an increase in real income.

The case of electronics/hardware, where until very recently many sub-sectors enjoyed zero import tariffs, is particularly interesting. There are 17 sub-sectors in electronics/hardware that imported goods worth more than US \$100 million in FY17. It can be seen from Figure 1 that imports of parts of telephone apparatus reached an

astounding US \$6.2 billion in FY17. All these sub-sectors had zero tariffs, which resulted in lower costs and the impressive penetration of mobiles/smart phones/electronic devices is there for all to see.

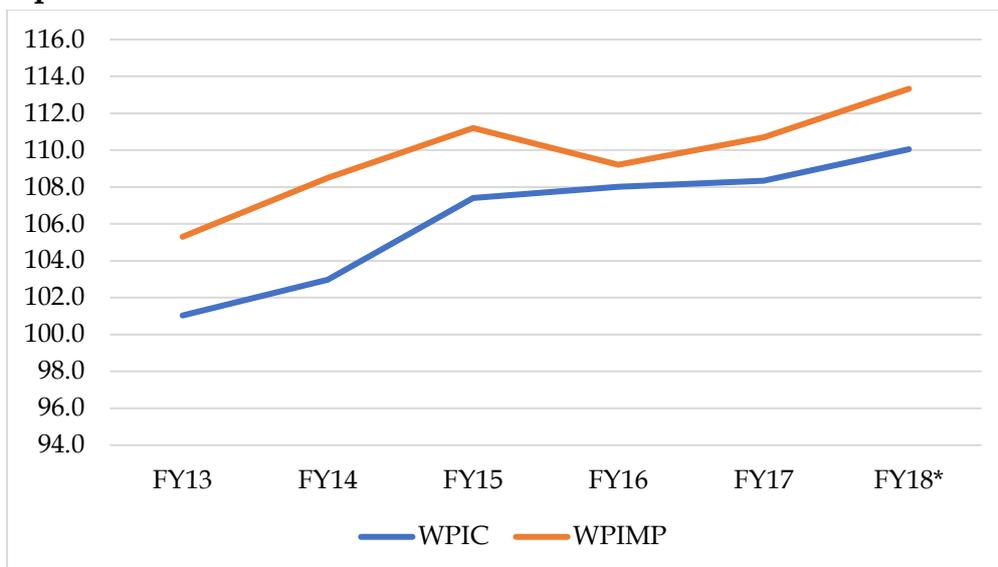
**Figure 1 Imports of selected sub-sectors of Electronics/Hardware in US \$billion**



Source: CEIC database

Due to the large-scale imports in the electronics sector, the wholesale price index (WPI) for computers, electronics and optical products has been persistently below the WPI for manufactured products as a whole for these years.

**Figure 2 WPI for Manufactured Products and WPI for Computer, Electronic and Optical Products**



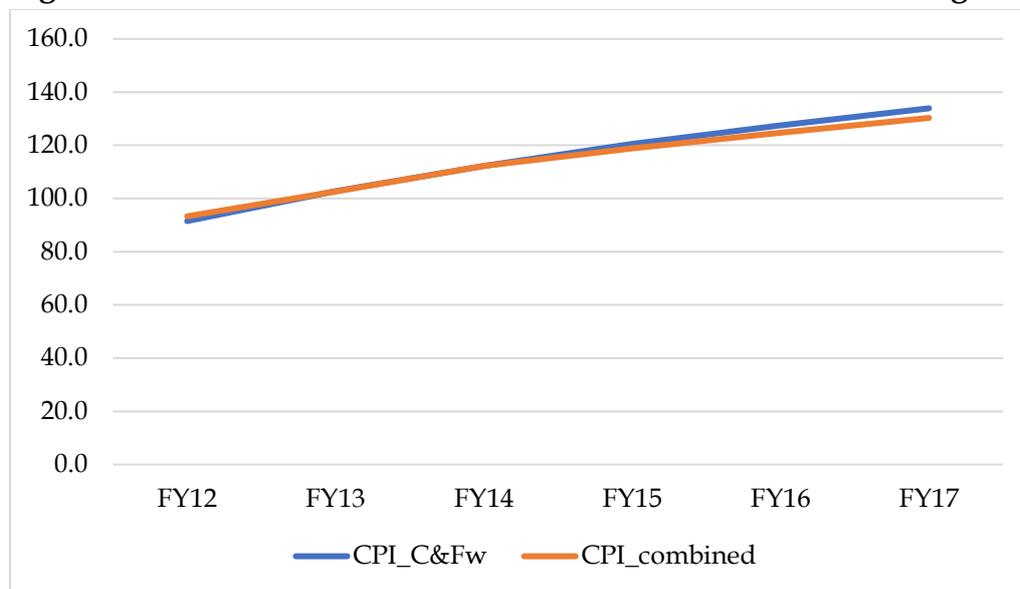
\*-FY18 is till Jan 2018. Base year is 2011-12.

Source: CEIC database

Thus, it can be argued that opening up the sector to imports has kept prices level below the average general price level. Lower prices have made electronic items more affordable.

As a counter example, let us now look at a sector that has some amount of tariff protection and see if it matches this performance. Take, for instance, the clothing and footwear sector, which has a level of tariff protection of at least 10 per cent. The consumer price index (CPI) for this sector vis-à-vis the overall CPI (urban and rural) can be seen in Figure 3.

**Figure 3 CPI for Rural and Urban combined and CPI for Clothing and Footwear**



Base year is 2012

Source: CEIC database and RBI

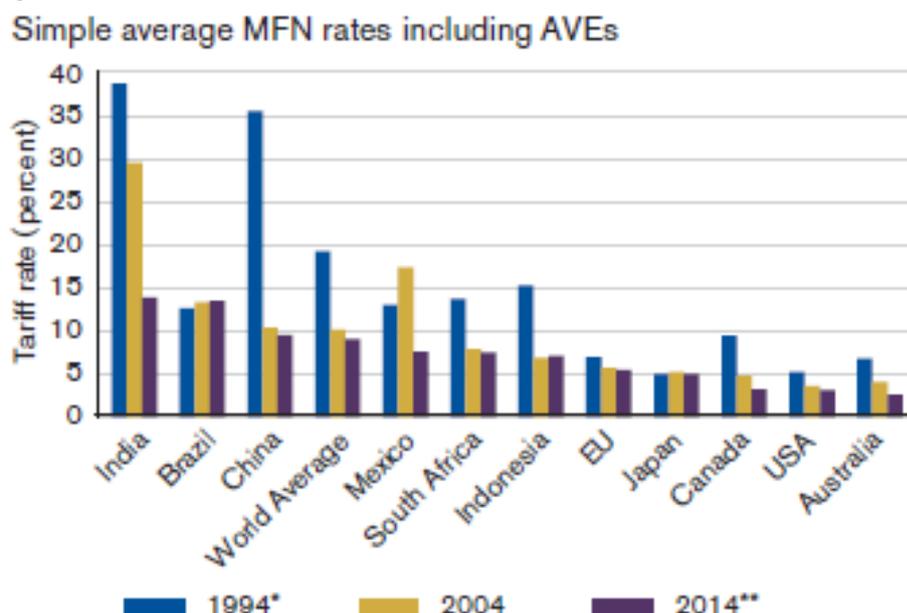
The figure shows that CPI for clothing and footwear matches or exceeds the CPI for all goods. Thus, despite import protection, this sector has not been able to lift its productivity and efficiency as a result of which consumers have not benefitted from lower prices.

## Tariffs and their impact

There is enough economic evidence to prove that trade helps in better resource allocation – we import what we are not good at and export what we are good at. Thus, resources in an open economy are utilised better than in a closed economy. Amity and Konings (2007), in their study on the impact of reduced tariff on intermediate goods in Indonesia, conclude that a 10 per cent reduction in import tariffs lead to productivity gains of 12 per cent for firms that import their inputs. They also report that productivity gains from reducing tariffs on intermediate goods were at least twice

as large as the gains from reducing tariffs on consumer goods. Hence, there is a strong case for policy makers to reduce import tariffs on intermediate goods. Static analyses by the Peterson Institute of International Economics during the 1990s showed that the cost of protectionism ranged between 1 and 7 per cent of GDP in economies such as the EU, the US, Japan, Korea and China. Figure 4 shows the tariff levels for selected G20 economies.

**Figure 4 Tariff Levels for select G20 economies**



Note: AVEs are ad valorem equivalents calculated by UNCTAD in order to account for duties that are not related to the import price of a product.

Source: *Kommerskollegium* (2016)

It can be seen that for all the three years, i.e., 1994, 2004, and 2014, India had the highest tariffs among the reported economies. Thus, other G20 countries have been more open compared to India. A comparison of this figure with Table 1 is instructive.

**Table 1 Share of Imports and Exports of selected G20 economies in 2014**

Country	Share of World imports in %	Share of World exports in %	Share of Exports/Share of Imports
India	2.63	1.39	0.53
Brazil	1.31	1.25	0.95
China	11.19	13.11	1.17
Mexico	2.29	2.31	1.01
South Africa	0.57	0.72	1.26
Indonesia	1.02	1.05	1.03
Japan	4.70	4.01	0.85
Canada	2.64	2.71	1.03
USA	13.41	8.26	0.62
Australia	1.30	1.43	1.10

Source: *The 18<sup>th</sup> Global Trade Alert Report*(Evenett& Fritz 2015)

India has the highest tariff among the selected countries and has the lowest ratio of its share in global exports to its share in global imports. Only the US comes close to India but there is no comparison as the biggest export of the US (the US dollar) is hardly accounted for in real goods and services. Even Brazil, whose tariffs seem to have risen of late, does much better in exports than India.

The table underlines the fact that exports from India are simply uncompetitive; the government needs to create conditions for a productivity surge in the domestic sector – by conditions, to name a few, we imply the requisite infrastructure (power, ports, faster custom clearances etc.) and incentives for industries. Increasing tariffs probably should be the last measure for improving productivity; as already mentioned, lesser import tariffs reduces input costs for value adding small companies. These small companies provide most of the jobs in the manufacturing sector and account for a significant share of exports.

### **Is the ground reality as simple as it seems?**

One of the sub-sectors where the Budget 2018-19 increased tariffs was silk fabrics; tariff was increased from 10 to 20 per cent. India had first imposed an anti-dumping duty on silk fabrics in 2006, which was later extended in 2011, and was in force until December 2016. Imports have subsequently increased – for example, imports increased from INR141 crore in April-November 2016 to INR171 crore for the same period in 2017. Of course, now the sub-sector enjoys increased import tariff. This clearly signals that despite having an anti-dumping duty for 10 years, this sub-sector could not climb up the efficiency and productivity ladder. Part of the reason for lower levels of productivity is that a majority of units in this sub-sector are micro, small, and medium enterprises (MSME), which require scale to improve their productivity and efficiency levels. These manufacturing units have to be encouraged to scale up by providing the right kind of physical as well as institutional infrastructure. Table 2 shows the production of silk sarees in the country across handloom and power loom units.

**Table 2 Production of silk sarees in square metres/month/unit in 2009**

<b>Unit</b>	<b>Average production</b>
Powerloom with 1 worker	1139
Powerloom with 2-5 workers	3382
Handloom with 1 worker	198
Handloom with 2-5 workers	1056
Handloom with 6-10 workers	997
Handloom with 11-20 workers	1473
Handloom with 21-50 workers	4105
Handloom with 51-100 workers	5399

*Source: Bedi et al. (2009)*

If one assumes the length of an average saree as six square metres, a handloom unit with one worker produces just one saree per day. This productivity per day remains the same for a handloom unit with 51-100 workers. On the other hand, the productivity of a power loom unit with one worker is six sarees per day, while that with 2-5 workers is 20 sarees per day. The table also underlines the predominance of micro and small enterprises in the sector. This, coupled with the fact of rising imports, indicates that in the last 10 years, the government has not been able to provide an environment in the sub-sector that encourages scaling up of enterprises. Clearly, what is required is policy emphasis and direction at the sub-sector level. For this, we need to understand sector specific problems that prevent the achievement of sufficient scale. The most important thing is the lack of a reliable supply of quality inputs - in this case, raw silk.

### *Raw Silk - Insufficient Production and unpredictable imports*

According to the Central Silk Board, there are around 50000 power loom and 2.5 lakh handloom silk fabric manufacturers in the country. For silk fabric producers in India, silk yarn accounts for more than 50 per cent of the total operational costs, with its proportion in total cost rising up to more than two-thirds in the case of handloom units. Table 3 shows the break up across various types of powerlooms and handloom manufacturers in the country.

**Table 3 Silk yarn as a part of operational costs in 2009**

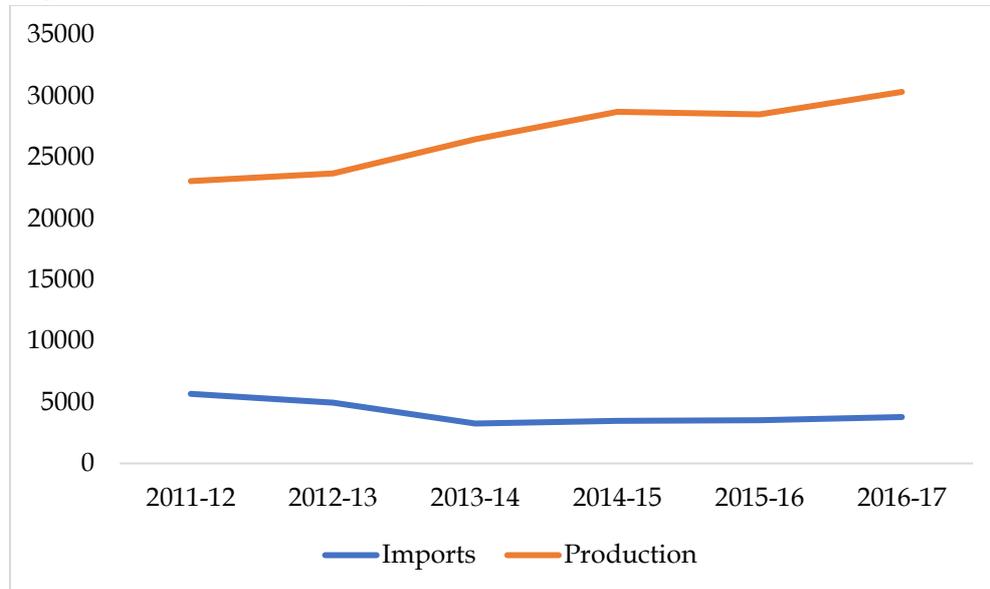
Unit	Silk yarn cost as a % of total operational cost
Powerloom with 1 worker	52.2
Powerloom with 2-5 workers	56.1
Handloom with 1 worker	69.5
Handloom with 2-5 workers	88.2
Handloom with 6-10 workers	75.5
Handloom with 11-20 workers	76.3
Handloom with 21-50 workers	79.2
Handloom with 51-100 workers	69.5

*Source: Bedi et al. (2009)*

As a proportion of total operating costs, handlooms bear the highest proportion. We also have noted that there are around 2.5 lakh handlooms in the country, which form the client base for the silk yarn produced in the country. India is the second largest producer of silk in the world after China, with China's production in 2016 being five times that of India. The consumption of raw silk in India generally exceeds production, with imports hovering around 10 to 20 per cent of domestic production. Imports primarily cater to the power looms in the country. It is reported that sericulture is practised in over 60,000 villages in the country with more than six million

people engaged in it. In 1995, as a sop to his constituency, H.D. Devegowda banned Chinese silk yarn imports; however, due to its superior quality and its importance to powerlooms, smuggling of Chinese silk became rampant. This ban was revoked in 1998. Under its commitment to the WTO, India abolished quantitative restrictions on silk yarn imports, which led to a sharp increase in imports. To protect the livelihood of domestic sericulturists, tariff or anti-dumping duty was then imposed on raw silk. Between 2011-12 to 2016-17, imports of raw silk have ranged between a high of 5,683 MT and a low of 3,260 MT. Figure 5 gives a better idea of production and imports of raw silk (MT) in India.

**Figure 5 Production and imports of raw silk in India (MT)**



Source: Central Silk Board, Ministry of Textiles, Govt

Downstream processors especially powerloom units, face shortage of raw silk, which is catered to mainly through imports from China. Compared to Indian silk yarns, Chinese yarns are lighter and smoother with less winding breakage and thus lends itself well to powerlooms. China is also the leading supplier of raw silk in the world; no wonder powerlooms prefer Chinese silks to the more durable but less dependable Indian silk. Hence, there is need to make Indian silk more reliable in terms of availability as well as quality. Fluctuating prices and uncertainties in the availability of raw silk lead to uneven production, making the weaving sector economically unviable.

### *Uneven quality*

An improvement in the productivity and quality of silk largely depends on the genetic potential of silkworm genetic resources. The genetic resources in India have already

been fully exploited; as a result there is very little scope for improvement in silk productivity and quality with locally available resources. Hence, efforts are being made by research institutions to procure better silkworm breeds with desired traits from other sericulture practicing countries like Japan, China, Bulgaria, Uzbekistan and Brazil. This is not an easy task, as such silkworm breeds from other countries are susceptible to infections and intolerant of high heat levels, both prevalent in the southern silk growing states of the country. Moreover, research takes time to fructify; therefore, the high yielding varieties cannot be adopted overnight. For example, production of the high yielding and better quality bivoltine mulberry (non-Indian variety) in 2016-17 was around 5,266 metric tonnes (MT) out of a total production of 30,348 MT, i.e., around 17 per cent. In contrast, the total production of silk in China in 2016 was 1,58,400 MT.

### *Inverted duty structure*

Another issue that has affected silk fabrics is the inverted duty structure (tariff on finished product lesser than tariff on raw material). Table 4 shows the total duty (in Rs) that had to be paid for a declared cost, insurance, and freight (CIF) value of Rs 100 for some selected dates.

**Table 4 Duty to be paid (in Rs) for a declared CIF value of Rs 100**

Date	Raw Silk	Silk Fabrics
01/03/06	31.3	22.9
01/03/07	31.2	25.7
07/12/08	31.2	20.8
07/07/09	31.2	25.7
01/03/10	31.2	28.1
01/03/11	6.5	28.1
14/07/11	6.5	30.1
01/03/13	16.2	30.1
11/07/14	16.2	25.1
01/03/15	16.6	30.7
01/03/16	11.4	30.7
01/07/17	11.4	17
02/02/18	12.1	29.4

Source: EximGuru.com, Accessed on 14<sup>th</sup> May 2018

From 2006 until 2011, the inverted duty structure in the sector is apparent. However, since tariffs were being increased steadily, imports, though high, were falling during this period. Imports in 2011 were 57.8 per cent lower than that in 2007. Figure 6 shows the trend of silk fabrics imports into the country.

**Figure 6 Imports of silk fabrics in India (MT) & price per unit kilogram (US \$/Kg)**



LHS is quantity, while RHS is price per unit kilogram

Source: UN Comtrade

From March 2011 until March 2013, duty paid for silk fabrics was much higher than that for raw silk. In July 2017, the difference in duty paid for silk fabrics was not substantially different from that for raw silk, reversing to a small extent the precipitous drop in imports in 2011-13. The inverted duty structure also resulted in power looms losing their competitiveness. Price per unit of imports shows a trend that is the reverse of the trend in imports, indicating the impact of the correction in tariff. It can be observed from Figure 5 that imports of raw silk have risen only when domestic production has declined, indicating the efficacy of the protection offered to sericulturists. Thus, the policy has been successful in protecting sericulture in the country while leaving the downstream value adding sectors to the vagaries of international trade.

Given the nature of agricultural markets, the political economy, and lack of a social security net in the country, government cannot leave the silk rearing sector, which has been providing employment to millions, to market forces. This implies that the powerloom and handloom units will have to bear some of the cost of protection given to silk farmers. This extra cost incurred by the employment intensive silk fabric industry can be passed on to the final consumer only if it is competitive to imported silk fabrics. Imported silk fabrics enjoy economies of scale in their home countries and thus have a cost advantage over local suppliers. It is this advantage the tariff seeks to nullify. However, the situation for power and handlooms may change when the home-grown bivoltine mulberry (non-Indian variety) is able to completely cater to their demand, after which powerlooms can probably scale up and handlooms can

become niche. Until then, government intervention in the market is called for in the silk fabric sector.

### **Concluding observations**

Freeing up imports increases the real income of the poor by making products available at lower prices. Now that developed countries have become protectionist, imports will become even cheaper. Increasing tariffs for industry protection does not necessarily translate into an efficient and productive domestic sector. It is well known that a better policy option would be to free imports as well as create conditions to improve the competitiveness of the domestic sector. However, this is a long run solution. Meanwhile, given India's swelling labour force, in the short run, some employment intensive sectors require protection so as to nullify the impact of imports on job conservation and generation.

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