Devaluation Versus Import Surcharge-cum-Export Bonus: A Comment.

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November 1965

PAKISTAN INSTITUTE OF DEVELOPMENT ECONOMICS
OLD SIND ASSEMBLY BUILDING
BUNDER ROAD, KARACHI-1,
(PAKISTAN)
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Introduction

The proposal of an import surcharge has been put forward in several papers published in the P.D.R. The proposal is not a new one but it has recently generated a renewed interest on the part of economists and government officials. The purpose of this paper is to compare (under some restrictive assumptions) the surcharge cum bonus policy with the more orthodox one of devaluation. The paper attempts to determine the extent to which these two alternatives differ. Criteria for choosing between the two alternatives are defined and the advantages of devaluation are enumerated.

The Problem

All countries which have fixed or quasi-fixed exchange rates find themselves at one time or another in a position where at the prevailing exchange rate, the balance of payments is in disequilibrium, i.e. where the demand for foreign exchange either to import goods and services or to export capital, is greater than the supply which is obtained from the export of goods and services or from the import of foreign capital.

The stock responses to balance of payments disequilibrium are devaluation or domestic deflation. In developing economies where the pressure on the balance of payments is often due to the

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implementation of an active development program in the face of stagnating exports, the solution lies in devaluation.

Devaluation, however, is not always appropriate for these countries particularly when the foreign demand for their exports is inelastic. In these cases, devaluation would have the desired effect of reducing imports but would also have the undesired effect of reducing foreign exchange earnings (since the price of exports in foreign currency would decline). In cases where both the domestic demand for imports and the foreign demand for exports is inelastic, devaluation would lead to an even further deterioration in the balance of payments position.

Multiple exchange rates are one way for these countries to restore balance of payments equilibrium without the cost of reducing their overall earnings of foreign exchange. The purpose of multiple exchange rates is to create a gap between the price which importers must pay for foreign exchange and the price which exporters receive for these earnings. By increasing the former the demand for imports is reduced; by holding the latter constant the same volume of exports will earn the same amount of foreign exchange. More subtle distinctions can be made; if only a portion of a country's exports face an inelastic demand curve then there can be two rates for exports—a higher price being paid for those exports which have an elastic demand.

Since multiple exchange rates are not considered respectable (and are frowned upon by the I.M.F.) they must be introduced under various guises such as foreign exchange auctions, import licensing, and import surcharges to limit the inflow of imports; export bonuses to increase exports of commodities facing an elastic demand and export taxes to restrict exports of those commodities which face an inelastic demand. Through these devices, a country can achieve the results of multiple exchange rates while at the same
time maintain only one official exchange rate.

The Pakistan Case

Since the end of the Korean boom Pakistan's balance of payments has been in chronic disequilibrium in the sense that at the official rate of exchange the demand for foreign exchange has exceeded the supply. In November 1952 import licensing was introduced to allocate the supply of foreign exchange. There have been considerable changes in licensing since then but the basic feature of foreign exchange allocation through licensing still remains.

Both prices and the volume of Pakistan's exports continued to decline after 1952 until in 1954-55 the value of exports was less than one half of the 1950-51 value (when earnings were at their peak). In July 1955 the Pakistani Rupee was devalued to the current price of Rs. 4.765 per U.S. dollar. In January 1959 the government instituted the export bonus scheme as a further partial devaluation of the Rupee. Almost all commodities are on the export bonus scheme. The important exceptions are raw cotton and jute.

Since Partition Pakistan has levied export duties on some of its exports. These have gradually been eliminated until currently they are levied only on raw jute, cotton, fish and poultry and eggs. Export taxes have primarily been a revenue measure although they have been justified as a means of preventing the further decline in the price (expressed in foreign exchange) of Pakistan's primary exports.

1/ For a description of the licensing system see \[4\]
2/ For a description and analysis of the export scheme see \[1\]
3/ For a discussion of their importance in total government revenue see \[3\]
Pakistan has moved towards a de facto multiple exchange system by means of import licensing, import tariffs, export bonus and export taxes. The particular collection of policies chosen have had some disadvantages particularly the method of allocating foreign exchange. Since at the present exchange rate there is an excess demand for foreign exchange the government allocates the available supply to industrial users of imported raw materials and capital goods and to commercial importers who resell to households and industry. Implicit in getting a license is a substantial wind-fall profit since imported goods can be sold at very large mark-ups over their c.i.f. values. Besides giving large "license created profits" to importers, the system encourages the use of imported raw materials and capital goods since to the industrial importers at least, these are valued at the official exchange rate rather than their true scarcity price.

In order to transfer the "license created profits" to the national treasury and improve the allocation of scarce imports by making their price reflect their true opportunity costs economists have advocated that an import surcharge be added to the existing system.

Background of the Surcharge Proposal

The idea of an import surcharge for Pakistan was first put into print, as far as I know, by Professor Emile Despres in an internal memorandum of the Planning Commission in December 1956. \[2\] The proposal was made at a time when exports of raw cotton and jute accounted for 72% of total exports and manufactured goods accounted for roughly 15% of the total. Further, the proposal came less than 18 months after the rupee was devalued.

The proposal of an import surcharge made against the circum-

\[5\] For a discussion and estimate of these margins see \[5\]
stances of 1956 made obvious sense. A further devaluation would not increase foreign exchange earnings; hence the way to wipe out the excess demand for foreign exchange and to improve the efficiency of its allocation, was to increase its price to importers. A foreign exchange auction was ruled out on the grounds that the I.M.F. would disapprove. The import surcharge was proposed as an alternative which would be acceptable to the I.M.F. and would accomplish the same objective.

Today there is a feasible alternative to the surcharge proposal. Pakistan already has a *de facto* partial devaluation implicit in the export bonus scheme. The alternative is to make this devaluation "official" and thereby simultaneously eliminating the excess demand for imports and accomplishing the results of the export bonus scheme without the bonus mechanism. By adding an import surcharge to the bonus scheme, Pakistan would be simulating the effect of devaluation.

In what follows, it is shown that whether the devaluation is "official" or simulated, the results will be very much the same. The choice between the two alternatives must primarily be made on "non-economic" grounds.

A Comparison of devaluation and surcharge cum bonus

The primary assumption made throughout the paper is that the purpose of a surcharge or devaluation is to eliminate the excess demand for imports by appropriating for the government the surplus arising out of this excess demand which has in the past accrued to importers. The purpose is not to reduce actual imports and increase exports but merely to change internal prices so that at the existing levels of imports and exports, the demand for and supply of foreign exchange will be equal.

Changes in exports and hence imports may result from the sur-
charge or devaluation but we assume that the government will take other appropriate measures to minimize these secondary effects.

In other words, we are not discussing the optimum amount of surcharge and bonus or devaluation - if in fact there is a unique optimum. Nor are we discussing which method would be best to increase exports and foreign exchange earnings above the existing levels. Although no less interesting than the problem discussed in this paper, these other questions are separable issues and not within the scope of this paper.

The demand side

Given the assumption enumerated above, the degree of devaluation which would be necessary to eliminate the excess demand for imports given the existing supply of foreign exchange would be equal to the rate of surcharge required to accomplish the same end. For example, if a 50% surcharge is the highest rate which would equate the demand for imports to the existing supply, then a 50% devaluation would be required to have exactly the same effect. The difference between the two systems is simply the way in which the price of imports is increased. Under the surcharge, the importer buys his foreign exchange at the current official rate but pays an additional 50% tariff on his imports. With devaluation the importer simply pays an additional 50% for his foreign exchange and does not pay any additional import taxes.

2. The Supply Side

Both the imposition of a surcharge or devaluation will affect the level of exports, earnings of foreign exchange and their imports.

A uniform surcharge on all imports will *ceterus paribus*, shift the demand for bonus vouchers (and bonus imports) to the left which in turn will lead to a reduction in the bonus voucher
premium and hence, in incentives to export. Exports of bonus items will be reduced; so will imports in subsequent periods.

The effect of devaluation on foreign exchange earnings is less clear. For non-bonus commodities facing an inelastic demand the relative decline in the foreign price will exceed the relative increase in quantity exported and hence exchange earnings are reduced. For non-bonus commodities facing an elastic foreign demand, the opposite is true. Changes in foreign exchange earnings from bonus exports will depend on the degree of devaluation relative to the present bonus earnings in addition to foreign demand elasticities.

We have already assumed that the purpose of the surcharge or devaluation is to eliminate excess demand for imports at the current level of imports. To do so, the government will have to adopt additional measures along with the surcharge or devaluation to protect foreign exchange earnings. There are many measures which can be taken. To simplify the discussion we have considered only the obvious ones which use existing policies and taxes. The conclusions, however, are not limited to these measures.

**Surcharge cum Bonus**

As explained above, the imposition of a surcharge will lead to a reduction in exports. This adverse effect could be prevented by exempting imports on bonus vouchers from the surcharge (or subject them to a different rate of surcharge) or by direct government intervention either to maintain the premium on bonus vouchers or to directly subsidize exporters of bonus items.

The extent to which the premium would be affected and hence the extent to which the government would have to subsidize exports by supporting the bonus voucher price will depend, among other things, on the substitutability of foreign exchange purchased directly from the State Bank and that purchased via bonus vouchers.
If all commodities could be imported both with or without bonus vouchers then the premium on bonus vouchers must fall to zero— for no one would pay any additional amount for foreign exchange than the official rate. The government would then have to pay exporters the total amount which they now earn from the bonus voucher premium. At current premium rates the government subsidy would be about 40% of the f.o.b. value of all bonus exports.

The current import policy is such that no commodity can be imported by both licence and bonus voucher; hence foreign exchange purchased directly from the State Bank is substitutable for that available via bonus voucher only to the extent that commodities imported under the two kinds of foreign exchange are substitutable. Even in the unlikely case of zero substitutability among these two categories of imports the demand for bonus voucher imports may still fall because of substitution with domestically produced goods and because of income effects. In any case, with some constraint as to which commodities can be imported with or without bonus vouchers, direct government subsidies to exporters would be less than the case where there were no constraints. The constraints, in effect, are additional taxes on the users of bonus voucher imports. These taxes are transferred directly to exporters.

The supporting measures for the import surcharge are either (i) what amounts to an elimination of the market in bonus vouchers, where the government (State Bank) simply buys foreign exchange earned on bonus exports at a higher rate (or rates if the present policy of differential bonus rates continues) than that earned from non bonus exports, or (ii) a combination of differential surcharge rates, limitations on what commodities can be imported without bonus vouchers and direct government intervention in the bonus voucher market.

1/ We are already assuming throughout that the import surcharge is sufficiently high to wipe out all excess demand for imports at the official exchange rate.
Devaluation

The effect of devaluation on total foreign exchange earnings depends on the foreign demand elasticities for Pakistan's exports and on the rate of devaluation relative to the rate implied by the existing bonus voucher system.

Exports facing an inelastic demand curve are the non-bonus items, raw jute, and more doubtfully, raw cotton. Bonus exports in general face an elastic demand.

Foreign exchange earnings from the inelastic non-bonus commodities would decline after a devaluation of the rupee. The foreign exchange loss can be prevented by increasing the level of the export tax on these commodities. Since we are assuming that the purpose of devaluation is to restore equilibrium from the demand side and should have as little impact as possible on the supply side, the increase in export taxes should be equal to the amount by which devaluation lowers the export price when expressed in foreign exchange. In this way, the export tax removes the price reduction implicit in devaluation. Since the foreign price is unaffected, exports and hence export earnings from these commodities are unaffected.

Earnings from commodities currently exported on bonus will rise or fall depending upon whether the official devaluations were greater or less than the devaluation implicit in the existing bonus rates and premium.

Available evidence suggests that the official devaluation would be greater than the current de facto devaluation. The present export bonus scheme at current premiums give exporters a rupee return of between 140 and 150 per cent of the f.o.b. price valued

1/ For a discussion of the response of exports to the bonus scheme see 1
at the present official exchange rate. Data on domestic prices of imports\(^5\) suggest that the devaluation required to eliminate excess demand would be much greater than 50%.

Taking these results to be correct, the post devaluation foreign exchange earnings on all commodities facing an elastic demand will be greater than existing earnings under the bonus scheme.

Supporting measures for devaluation will include higher export taxes on the few commodities facing an inelastic demand. No additional measures would be required if the impact of devaluation on the exports of bonus items is accepted. If, however, the current composition and value must be preserved then, under the more plausible assumption about the magnitude of devaluation, the government would have to levy additional export taxes on commodities currently on bonus. Since there are currently differential rates of bonus, there would correspondingly have to be differential rates of export tax to preserve price relatives and hence composition.

Ease and Cost of Administration of the two Alternatives

From the discussion above it is clear that the administrative advantages of devaluation over the surcharge cum bonus system depend upon the number of additional constraints on the value and composition of exports which must be met. The advantage or disadvantage of devaluation is that it simultaneously determines, and in fact equates, the effective buying and selling price of foreign exchange. To the extent that the government wishes to maintain a number of buying and selling prices, devaluation has no advantage in terms of administrative convenience and cost over surcharge and export bonus schemes.

If the government would consider a system of surcharge cum bonus where there is only one rate of bonus and where the bonus
rate plus premium is equal to the rate of surcharge, then devaluation is definitely a superior way of achieving the same end. First it's easier to collect increased export taxes on the one or two commodities which face an inelastic demand than it is to collect higher import taxes on the full range of imports. Given the existence of tariff differentials, importers will try to circumvent the higher rates by exploiting various loopholes such as ambiguities in commodity definitions. With a surcharge added to the already high rates of duty, the incentives to find means of reducing import tax levies will increase.

Second, devaluation eliminates the need for the export bonus scheme and all the resources which are required to administer it.

Revenue Implications

The import surcharge is often advocated on the grounds that it is a means of increasing government revenues. As noted below, government revenues will increase in both the devaluation and surcharge cum bonus systems. Either alternative can raise more than the other by driving a larger wedge between the effective price the government pays for foreign exchange and the effective price for which it sells it. The extra revenue, however, comes at the cost of reduced exports and less efficient resource allocation. Since the allocation inefficiencies of the present system are often quoted in support of a surcharge, it is difficult to see how advocates of the surcharge can also argue in its favour, as opposed to devaluation, on the basis of increasing tax revenue. If the surcharge is to be levied in such a way that it does not have adverse effects on resource allocation then the revenue derived from the surcharge will be the same as the revenue derived under devaluation.

In considering tax revenue from the surcharge on imports we
first consider those imports which are financed by foreign assistance. Government revenue from this source is the same in both cases. Foreign aid can be viewed as transfers of foreign exchange from foreign governments and international agencies to the Pakistan government which in turn sells this foreign exchange to importers. The government will get all of the rupee proceeds from the sale of this foreign exchange whether they sell it at the current official rate then collect a surcharge or whether they sell it at the new (post devaluation) rate and collect no surcharge.

Now consider those imports financed out of export earnings of non-bonus items. Under the surcharge cum bonus system, government revenues are the import surcharge plus current export duties. Under devaluation revenue is from export taxes only. The increase in export taxes is equal to the rate of surcharge. Hence, tax collections are the same under both alternatives.

Finally, consider those imports financed out of the export bonus items. With devaluation, government revenue from these imports is zero. Under the surcharge cum bonus system government revenue arises out of the difference in the rate of surcharge on imports and the rate of bonus paid to exporters. If these two rates are the same, the surcharge cum bonus system is identical with devaluation.

If the rate of surcharge exceeds the bonus paid to exporters of bonus items the government will have larger revenues under the surcharge cum bonus scheme than it would by devaluation.

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1/ Actually, as pointed out later, revenue from the surcharge will be less than after devaluation to the extent that foreign exchange is not used to import commodities.

2/ In order to maintain the volume of exports and the earnings from them, it would be necessary to equate the increase in export taxes to the rate of devaluation which in turn, is equal to the rate of surcharge.
The difference in governmental revenue under the two schemes is equal to the product of the difference between the surcharge and bonus premium and the f.o.b. value of bonus exports. With the currently prevailing composition of exports the base on which this extra revenue is collected is relatively small. Even for relatively large differences between the surcharge and bonus premium, the extra revenue collected under the surcharge cum bonus system is not going to be very large.

Increasing revenue in this manner has two adverse effects which must be weighed against the benefits of the extra revenue. First, if there is a gap between the surcharge rate and the export bonus rate then exports will be less than they would be if the gap were zero or, what is the same thing, less than they would be under devaluation. In effect, the gap is a tax on bonus exports and an indirect subsidy to domestic consumption.

Second, all tariffs on imported raw materials and capital goods which are not offset by an export bonus of the same magnitude drive a wedge between the price that domestic manufacturers pay for imported inputs and the price they receive when they re-export those inputs embodied in domestic manufactures. In other words, a gap between tariffs and export bonus is a tax on export industries using imported inputs.

A case can be made that it is precisely this kind of export industry in which Pakistan has a comparative advantage. Pakistan has a comparative abundance of cheap labour but is relatively poor in other resources. The potential for an export industry then lies in importing raw materials adding cheap labour and exporting the finished product. A more specific proposal of this type has been made by Norman Van Scherpenberg. He has argued that one relatively easy and obvious way to develop an export industry is for Pakistan to produce relatively labour-
intensive components of commodities which are currently, wholly produced elsewhere. A gap between total tariff charges and the bonus rate would tax this kind of specialization and hinder its development.

These adverse effects are already a feature of the existing system. The argument here is that these distortions can and should be reduced at least to the extent of equating the rate of bonus premium to the rate of import surcharge. The surcharge cum bonus system will yield higher government revenues than those available through devaluation only by having a higher degree of distortion than under devaluation.

Arguments against devaluation

Besides the revenue aspects discussed above there are several standard arguments against devaluation:

1) the demand for Pakistan's exports are inelastic,

2) the I.M.F. is against it,

3) it will make India happy.

We have already discussed the first objection. At most only a few commodities face an inelastic demand. The prices of these can be protected by increasing the export tax on them. As for the second argument I think that I.M.F. resistance to devaluation is exaggerated. In any case, the I.M.F. surely are more opposed to surcharges and multiple exchange rates for bonus and non-bonus items than they are to devaluation. The third argument is said to be the most important. From the economic point of view it is irrational. To the extent that Pakistan and India compete in foreign markets, devaluation by Pakistan will lead to Pakistani gain in trade at the expense of India. Besides, there is good reason to think that India would follow Pakistan in any devaluation. It is always difficult to assess the political and psychological effects
of devaluation but these can be exaggerated.

Arguments for devaluation

We have already pointed out the case where devaluation has administrative advantages over a system of import surcharge and export bonus.

Other arguments for devaluation involve
1. magnitude of foreign exchange loss through the black market,
2. coverage of devaluation,
3. the "mirage" effect.

Devaluation is preferred to a surcharge in its effect on the black market for foreign exchange because an increase in the official price of foreign exchange will shift the black market supply curve upward and to the left. *Ceterus paribus* the black market price will rise and the quantity exchanged illegally will be reduced. An import surcharge would continue the current low rupee price of foreign exchange and hence the current rate of foreign exchange loss.

The second point concerns the non universality of the import surcharge. Tariffs are levied on imports of goods. Thus, foreign exchange which is used for other purposes such as trips abroad, education abroad--and in fact all of the items included under "invisibles" in the balance of payments account are purchased at the official rate of exchange without any surcharge. There is no reason why the purchasers of these services should not also pay the true opportunity cost of foreign exchange. Of course, one can always devise a special tax to cover these items too.

The third argument is referred to as the "mirage" effect because the official exchange rate is not the "real" exchange rate. Perhaps the economists will not be fooled but most people are not
as sophisticated in the fine tricks of the profession. The public will continue to think that the real exchange rate is Rs. 4.75 to the dollar (after all it is for some purposes). When the surcharge is levied the public will raise their voices in indignation at the prohibitive tariffs, which will be obvious to see, in much the same way as they decry the profits accruing to current license holders. Since individual tariffs can be changed many cases for special consideration will be made on the basis of need, encouragement to domestic industry and other worthy causes. The government may not give way to this public pressure but it will undoubtedly have to expend a great deal of energy and time trying to convince the public that the surcharge is the same as devaluation even though it does not include invisibles and capital account transactions.

To get some idea of the misunderstanding which is generated when a country tries to simulate devaluation one need only recall the reaction to the recent British surcharge and export promotion scheme. Very few countries see this as a temporary devaluation and many countries, including Pakistan, are seeking exemption from it.

Devaluation on the other hand is viewed as irrevocable and no one would think of asking to be exempted from it.

The Issue

We have shown that a surcharge cum bonus system can be designed to have exactly the same results as devaluation and vice versa. Devaluation has some advantages over surcharges and export bonus programs except where the government wishes to maintain an intricate multiple exchange system. In such a case, neither alternative has a clear advantage.

The maintenance of more than one exchange rate leads to a
misallocation of resources--except in the presence of externalities. While it is to Pakistan's advantage to exploit her monopoly position in jute (and possibly cotton) and should keep the effective exchange rate for this commodity low, we have argued that in all other cases the gaps between the effective exchange rates for imports and exports should be reduced.

In the end, the advocates of devaluation are advocating the elimination of the major portion of discriminatory taxes on imports and exports which make up the current exchange system. The advocacy of devaluation is a call for simplicity and orthodoxy; a call to restore to the exchange rate the role of a price which by reflecting the true opportunity cost of foreign exchange leads to its efficient use.
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