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Getting Connected

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Trade policy focusing on global supply chains and the path to inclusive, sustainable growth for India

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ABOUT THE AUTHOR

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Getting Connected: Trade policy focusing on global supply chains and the path to inclusive, sustainable growth for India

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Introduction

Trade economists traditionally have focused on issues that are central to trade negotiations for greater market access. Given that historically trade related tariffs were high, and therefore constituted a significant barrier that was easily identifiable and measured, trade policy and the primary discussion around trade negotiations largely revolved around such barriers.

However, with the development of fragmented production networks and the rapid evolution of a global consumption and production system managed by multi-nationals, trade barriers which directly impact this global production and consumption supply chain are rapidly growing in importance. In fact, while tariffs remain high in certain cases, they are no longer the primary barriers to trade. The critical challenges are related to non-tariff barriers, both at the border and behind the border, and issues related to trade facilitation, i.e. the cost and efficiency of logistics due to both poor regulation and/or poor infrastructure. Unfortunately, a significant number of developing countries are yet to recognize the importance of these barriers, particularly: reducing trade transaction costs, streamlining regulations, promoting trade and investment in professional services, and strategic regional integration to link its manufacturing to the vast and rapidly expanding regional and global supply chains. This is the global trade landscape that has evolved over the past thirty years. This calls for countries to adopt the next generation trade reforms.

[1]The views expressed are personal and should not be attributed to the organization the author is affiliated with.

Next Generation Trade Reforms

International trade has grown immensely over the past 30 years, growing on average twice as fast as global output since 1980 (WTO, 2013). While there are many factors that have and will continue to shape the world trading system –such as greater international cooperation, demography, socio-economic factors, deposition of natural resources, and political institutions–technology has been a key driver for the rapid evolution of international trade over the past three decades. Advances in production technology, IT and telecommunications and transport logistics have incentivized businesses to delocalize their production networks; a phenomenon that has grown tremendously since the 1980's (UNCTAD, 2011). As Hoekman (2013) writes:

"Much of the growth has been in intermediate products and services that move from country to country in a company's international supply chain. Value is added to a product in each of the countries that are part of the chain. By locating activities and tasks in different countries according to their comparative advantages, the total cost of production can be reduced."

As a result, worldwide trade has become increasingly fragmented with different phases of production increasingly taking place in many different countries, giving rise to increasingly complex Global Supply Chains (GSCs). GSCs can be thought of as a system of value-added sources and destinations within a globally integrated production network. Along this global production system, producers purchase inputs and then add value, which is included in the cost of the next stage of production (Koopman et al, 2010).

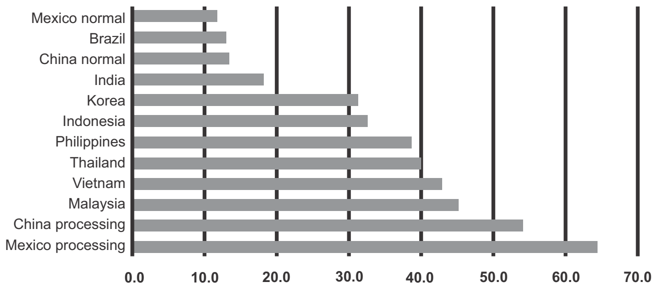
Export oriented economies that prioritize a new set of next generation trade reforms to achieve supply chain integration are much more likely to enjoy periods of sustainable and inclusive growth, while those who do not will be left behind. In order to compete in this new global trading landscape, policymakers must focus on three key next generation trade reform areas: 1) supply chain integration through trade facilitation and logistics reforms paving way for rapid growth of exports and

FDI; 2) diversification of trade in services, especially to professional services beyond just Information Technology (IT) and IT-enabled services; and 3) strategic focus on regional cooperation and integration to take advantage of regional specialization, economies of scale, market size, and production capacity (Roy, 2013 May 19). This paper focuses mainly on policies to achieve the first, greater supply chain integration; however it is important to recognize that these reform areas are closely interlinked.

GSC Connectivity and Inclusive Growth

Over the past 30 years, GSCs have played a huge role in international trade. The extent to which GSCs have expanded over the last few decades is evident when analyzing trade data, which shows that the foreign content of final goods has risen rapidly: traded goods contain more and more inputs from different countries. The WTO estimates that almost 30 percent of total trade consists of re-exports of intermediate inputs, a measure which has risen 10 percentage points since the mid-1990s (WTO 2013). The level of success among countries for achieving integration, indicated through higher foreign content of goods, varies, with Emerging Asia, and Mexico coming through as a clear frontrunner amongst emerging countries (Figure 1).

Figure 1: Foreign Content of Final Goods Exports (%)



Source: Koopman et al. (2010) NBER Working Paper

It is also important to recognize that some of the most important traded manufactured goods like electronics, automobiles, engineering, textiles, and certain classes of high-value chemicals are increasingly produced and delivered with a highly fragmented production network. An illustrative example is that foreign countries contribute 80% or more of the value added embodied in Chinese exports of computers, office equipment, and telecom equipment (Koopman et al, 2010). It is interesting to note that the percentage of foreign content in exports from special zones in China (China Processing), and Mexico are so much higher than their exports from outside the zones. Modern and effective zones and innovative clusters were created in these countries to better integrate into the global supply chains, and largely financing these through FDI. Unfortunately, India's attempts with government-controlled SEZs are completely out of line with these modern concepts of zones and clusters!

The rise of global supply chains and their effect on international trade represents a huge opportunity for emerging and developing countries to get on a path of sustainable and inclusive growth. Greater participation in GSCs enables producers along the production network, via management and technological diffusion, to become more competitive overall. In turn, countries that effectively integrate into international supply chains can enjoy greater levels of employment, productive capacity, and greater growth. And moreover, these positive externalities increase the attractiveness of the country as a place for doing business, attracting greater levels of Foreign Direct Investment (FDI) and other types of capital flows.

It is important to note that trade and business facilitation policies promote *inclusive* growth, allowing small- and medium-sized enterprises (SMEs) to gain access to export markets. Trade impediments tend to be more difficult for SMEs to overcome since large upfront investments are often needed. For example, the 2013 WEF Enabling Trade report found that many small firms found the personnel and time investments needed just to understand country-specific regulatory requirements, prohibitive. A "Perceptions of SME Survey" jointly carried out in 2006 by the OECD/APEC found that customs and procedures and domestic regulations are one of the most widely reported barriers to competitiveness (Fliess and Busquets, 2006).

Overcoming hurdles for SMEs is particularly important for emerging countries, in which SMEs are estimated to contribute up to 45 percent of employment and up to 33 percent of GDP (IFC, 2010). Additionally, SMEs contribute to economic development through positive externalities such as innovation and competition.

Getting Connected – Shifting Policy Priorities

In order to integrate into global supply chains, policymakers (and MNCs) need to prioritize improving the overall business environment that will reduce transactions costs behind the border, at the border and across the border.

Behind-the-border Transaction Costs

Behind the border transaction costs vary greatly by country and are largely dependent on a country's logistics capacity. Logistics reforms that impact transactions costs behind the border include: 1) transport infrastructure such as road, rail, ports, and airports; 2) reliable communications and technology infrastructure and 3) quality logistics services such as transport operators. Quality logistics behind the border allows for efficient and reliable movement of goods and services throughout the country, which translates into lower transaction costs (as well as greater SME market access by removing costly barriers). For example, the WTO (2013) estimates that the doubling of a country's paved roads can boost trade by as much as 13 percent. While logistics is a key driver of internal (or behind-the-border) transactions costs, other policies will also have a significant impact, including internal taxes or fees, competition-related restrictions on market access, and poor access to trade facilitating services, etc.

At the Border and Cross-Border Transaction Costs

Trade facilitation (TF) refers to policies that seek to minimize trade impediments and reduce costs at the border and across borders, facilitating greater integration with global supply chains (Mann). While most attention is typically given in TF to customs modernization efforts, the ambit of TF includes many other important areas, such as port logistics, customs procedures, standards harmonization, business mobility, trade information and e-business infrastructure, administrative transparency and professionalism, and effective government institutions; all of which have a substantial impact on transactions costs and the ability of countries to integrate into global trade (Roy 2013, June 24). According to UNCTAD, direct and indirect transaction costs, i.e., banking and insurance, customs, business information, transport and logistics etc., add up to 10 per cent of the total value of world trade, a staggering sum of $400 billion.

Traditional trade policy tends to focus on applied tariffs on final goods and intermediate inputs; however such focus is not sufficient to achieve supply chain integration. In fact, data shows that the relative importance of tariff policies is second to the potential impact business and trade facilitation reforms offer. Figure 2 below provides the estimated increase in trade that a given country group could achieve by improving its business environment to that of the next country-group by income. One can see that relative impact of applied tariff reductions are much smaller compared to the opportunity afforded by an improved business environment.

Figure 2: Relative impact of traditional trade policy versus overall business environement

Increase in trade (as a percentage) due to changes in:			
Policy Change	**1) Applied tariffs on processed and final goods**	**2) Applied tariffs on intermediates products**	**3) Business Environment Index**
Middle to high income	2.6	4.8	40.7
Low to middle income	7.9	7.9	27.6
LDC to middle income	5.1	13.1	37.7

Source: UNCTAD secretariat (2011)

New Institutional Framework for the Next Generation Trade Reforms

The rise of GSCs means trade in intangibles as defined by management of knowledge, data, and support services (IT and ITES) are becoming increasingly more important. The impending automation of many manufacturing and services functions is already starting to re-define the relationship between labor and capital. Such drastic changes require a highly efficient trade and investment environment (low transaction costs), and strategic thinking from the policy-makers who manage this relationship.

The current institutional arrangement in most developing countries that disperses strategic decisions to the Ministries of Commerce and Industry, Finance, and External Affairs lacks the necessary depth.

In order to separate the strategic decision making process related to trade and industrial policy from day to day operational issues, a new independent Trade Policy Council (TPC) needs to be developed outside the line ministries and which reports directly to the Prime Minister/Head of State. Its role could include strategic decisions on multilateral, bilateral, and regional trade policy, policy related to FDI, and policies related to trade facilitation and reducing transaction costs of trade including domestic regulatory reform, strategic policy making on improving country's competitiveness, and policies to improve logistical capacity and connectivity with the rest of the world including skilling and technological acquisition.

Why India is way behind in Linking to GSC compared to East Asian Economies

The key to successfully increasing Indian manufacturing exports is integration of manufacturing into global production networks. But high transaction costs of producing and trading across borders have meant that Indian manufacturing historically operates largely outside this system of production networks. India remains one of the least integrated emerging economies in terms of participation in global supply chains –Figure 1 above clearly shows that foreign content in final exports in India is just 18%, compared to over 30 percent in other emerging countries.

Global supply chains that define such production networks need to be cost effective, time bound and certain. None of which can be guaranteed in Indian conditions with poorly designed and implemented regulations combined with inadequate infrastructure. The integration of Indian SMEs, which have great potential, into such global networks, is especially held back due to such high transaction costs, as large Indian firms are often able to surmount the difficulties posed by working in the Indian environment and credibly signal their ability to do so. Thus, any government that seeks to champion the cause of SMEs, and growth of employment in manufacturing through export development cannot but take the issue of transaction costs and trade facilitation as a high policy priority.

The overall quality of logistics services and supply chain efficiency are dependent on the quality of regulatory services (business facilitation) provided by the government. These regulatory services include customs clearance, domestic indirect tax collection and processing, regulatory services related to the screening of health and other standards of imports, and local (state and municipal) tax collection. Other government services include those provided by public sector airport authorities, ports, highways, and rail container movement among others. The critical policy questions for India are whether a) it has a concrete plan in place to deal with the current challenges of trade and business facilitation, and b) whether there is a more longer-term plan for making India ready for the new trends in manufacturing that would require even more fundamental improvements in trade and business facilitation and supply chain efficiency.

The Indian government needs to shifts its focus immediately to trade and business facilitation reforms to boost trade as well as to attract larger inflows of FDI. India, with 250 million plus and growing middle-class consumers, will easily attract market-seeking FDI, i.e. investment that seeks to serve its domestic consumers irrespective of business environment. But the crux of becoming competitive and creating those extra millions of jobs that India desperately requires would lie in its ability to attract efficiency-seeking FDI, i.e. investment that uses India as a manufacturing base for global production and innovation. Such FDI would integrate Indian entrepreneurs into the global market by exposing them to the best technologies, marketing networks, and management systems.

Policy Recommendations for India

The critical elements of policy required to integrate into global supply chain are a) relatively low tariffs (to allow easy importation of intermediates), and a simplified tariff structure, b) regulatory environment that is attractive to FDI in manufacturing, c) a taxation system that ensures that no domestic taxes are exported (i.e. zero-rating of exports), d) an environment of low transaction costs of operating across borders, and e) strong logistical linkages, especially with regional economies. India currently lacks the comprehensive reform initiatives in place to achieve any of the five above mentioned critical elements. A basic policy objective to integrate into regional production chains in South East Asia should be to bring Indian applied tariff levels down to the levels achieved by major ASEAN economies (from 14 percent to 9 percent).

Integrating into international production chains also requires a domestic taxation system that is relatively transparent, stable, simple, and ensures that no element of domestic tax is passed on to exports. It is obvious that if the added cost of domestic taxes is passed on to the price of the exported product it will make such products less attractive for procurement within a price-sensitive global supply chain. One long-standing demand of Indian exporters has been the implementation of a long overdue comprehensive nation-wide goods and services tax (GST), Indian version of VAT, to replace a complicated domestic tax structure. A related demand has been the removal of all state and local taxes that are not rebated to exporters to ensure complete zero-rating of exports in terms of domestic taxes.

Tariff policy alone will not be sufficient. Simultaneously, we need to urgently push the remaining trade facilitation reforms which were outlined in the 2004 Ministry of Finance Working Group on Trade Facilitation Report that I chaired. The key recommendations were:

1. To rely on a system based on trust with reliance on self-certification of importers, and ex-post audits, and minimal physical inspection;

2. Speedy clearance with full reliance of a state-of-the art risk management system
3. Introduce full automation leading to a paperless system with minimum face-face-contacts and signatures
4. Cargo dwell time reduced to levels comparable to the best performers in South-East Asia
5. Most importantly, quarterly monitoring of cargo-dwell time in major ports and airports by a High-Level Inter-Ministerial Committee with the full attention of the Prime Minister

In addition, a comprehensive program to reduce the cost of movement of goods behind the borders from hinterland to ports needs to be undertaken. Its primary goal should be to identify the regulatory bottlenecks to fast and efficient cargo movement within India and their rectification. Such an initiative would need full participation of all key ministries, state governments, and the private sector, and would thus require considerable political support. The regulatory bottlenecks holding up development of ports, coastal shipping, and air-cargo should also be addressed.

As discussed in the previous section, India also needs to adopt a new institutional framework for trade policy outside the line ministries, reporting to the Prime Minister where strategic policies are undertaken separately from implementing these policies which, should be left to the line ministries. As previously (2013, September) spelt out, three different offices should fall under a Trade Policy Council reporting to the Prime Minister-Office of the Chief Negotiator for strategic decisions on multilateral, bilateral, and regional issues; an Office of the Chief Trade Economist to handle strategic decisions on regulatory policies, skill development and manufacturing competitiveness; and a Director General of Trade Facilitation to reduce trade, transportation, and logistics costs.

To highlight what is stated above, India's Chief Trade Negotiator must, as Hoekman and Jackson (2013) argue, "*Think supply chain* when designing trade agreements and move away from the traditional approach of looking at trade facilitation in specific areas such as product standards, customs valuation, and import licensing in isolation. For supply chain operation what matters are all the regulatory policies that affect the chain as a whole. An item-by-item approach may leave some important policy areas unaddressed".

India does not have the luxury of time. While supply chain efficiency is critical to manufacturing competitiveness, in the present scenario of mass production represented mostly by large-scale assembly line production systems that have remained more or less un-changed since the early 20th century, rapid changes fueled both by technology and shifting consumer preferences and behavior (driven by the emergence of the global middle-class) is going to bring some very significant changes in how manufacturing is organized and managed. Some of these trends are already visible in the growth of greater customization of both final as well as intermediate goods and the use of e-commerce platforms. Such shifts in how global production systems are organized are already seeing India's competitors putting in huge investments in logistics and trade facilitation. India risks being left behind, and thus the time for logistics, trade and business facilitation is now!

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Notes:

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to provide a forum for liberal intellectuals

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to promote an environment for free and fair public debates

...

to provide a platform to promote arts and culture

...

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