LEGISLATIVE ALERT

Vol.01 No.11 ISSN 0855-2452 A Publication of the Institute of Economic Affairs -- November 2001

SELECTED ISSUES IN TRADE REFORM AND LIBERALIZATION IN GHANA

by

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A Review of Developments in the International Sphere

Ghana's trade reform and liberalization policies must be analyzed in the context of the new multilateral and regional trading arrangements currently in place. Foremost among these is the WTO agreements, in as much as they govern all other trading arrangements. This brief highlights key elements and provisions of the key international and regional trade arrangements (i.e., WTO, ACP-EU and the Africa Growth and Opportunity Act). Ghana's trade reforms and policies since the Economic Reform Program are then examined in the context of their ability to foster domestic international competitiveness within the framework of the opportunities and constraints posed by the new trading arrangements. The final section provides examples of best international practices in the sphere of international trade and domestic competitiveness

WTO, EU-ACP, AGOA

Under the 1994 Marrakesh Treaty establishing the WTO, developed and developing countries resolved to promote free trade. As a result, both groups of countries are required to lower their tariff barriers and restrict the use of quotas and other non-tariff barriers. Consistent with this objective, tariffs on all agricultural products are now bound (i.e., have a ceiling). Previously, more than 30% of agricultural produce had faced quotas or import restrictions. However, over a six year period, commencing in 1995, these tariffs are gradually being reduced. In general, almost all import restrictions that did not take the form of tariffs, such as quotas, have been converted to tariffs - a process known as tariffication. In this context, Ghana committed itself to tariff binding and tariff reductions, tariffication of non-tariff barriers in agriculture, reduction of some domestic support measures/subsidies, provision of greater market access to other WTO members, liberalization of financial markets, and removal of import licenses

Elements of the ACP-EU Coutonou Agreement signed on June 23, 2000 were largely influenced by WTO agreements. Consistent with the WTO spirit of achieving free trade by December 31, 2007, the special concessions granted by the fifteen EU member states to the ACP countries will be replaced

Legislative Alert *is a monthly publication of the Institute of Economic Affairs, Ghana, a non-profit research institute and co-sponsored by the Center for International Private Enterprise in Washington D.C., U.S.A. and DANIDA, Ghana. Subscriptions to* **Legislative Alert** *are made available to those who make contributions to the IEA. Address all correspondence to: The Editor, Institute of Economic Affairs, P.O. Box OS 1936, Accra Tel. 244716 & 7010714.*

by new agreements that promote free trade and reverse the Lome Convention provisions of non-reciprocal duty-free access by ACP countries to the EU market. Although ACP countries will still have their present access to EU markets, the EU is bound to give similar duty free market access to exports of other countries.

Issues

The termination of the non-reciprocal trade concessions will mean unrestricted access to African markets for European goods, regardless of the effect on local agricultural and industrial production. Combined with the WTO's drive toward trade liberalization, it makes it increasingly imperative that developing countries adopt measures that promote efficiency and international competitiveness in the production of goods and services for both the export and domestic markets. Lower barriers to trade imply that domestic firms that produce import competing products will not be spared the ravages of unfettered competition. There is a small window of opportunity prior to 2007, when Ghana and other developing countries can still enjoy preferential treatment in EU markets (under the Coutonou Agreement) and US markets (under AGOA).

Given the dearth of time and the capacity and technological constraints facing domestic firms, Ghana can best exploit the small window of opportunity by **negotiating partnership arrangements with foreign firms** that have the production capacity, but lack preferential access to lucrative US (under AGOA) and EU (under ACP-EU) markets. Such cooperation however, requires substantial improvements in physical and social infrastructure, lower transactions costs, and the achievement of macro-stability.

The window of opportunity will however, close by end-December 2007. In this context, it is relevant to ask whether current trade policy and reforms are inimical or conducive to promoting the competitiveness of domestic firms. What measures should be adopted to promote the international competitiveness of domestic firms?

Ghana's Trade Policies in the Context of the New Trade Regime

The trade policy elements of the Economic Recovery Program marked a reversal of a protectionist trade regime in Ghana. It replaced an economic development plan based on import substitution with a growth strategy based on export expansion. Specific measures to effect this transition involved the tariffication of quantitative restrictions on imports, tariff rationalization, the removal of limitations on the availability of foreign exchange, a shift away from a fixed to a flexible exchange rate regime, and the elimination of price controls and agricultural subsidies.

Issue

However, to date, there is an absence of a clearly laid out strategic Trade Policy in Ghana, linking trade objectives and policies with other macro-economic indicators and overall growth. Elements of such a policy exist, but in an uncoordinated form in various official and unofficial documents. Such a document provides a context for evaluating the effectiveness of policy instruments such as tariffs and the exchange rate.

Tariff Trends and Domestic Competitiveness

Ghana simplified its tariff structure and removed quantitative restrictions after the introduction of the Economic Recovery Program in 1983. Prior to the 2001 Budget Statement, the tariff structure had three rates: 0 and 5 percent for primary products, capital goods and some basic consumer goods; a 10 percent rate for raw materials and intermediate inputs as well as for some consumer goods; and in 2000 a lowering of the top rate from 25 percent to 20 percent for final consumer goods. In 2000 a special 20 percent import tax was levied on 32 (currently 23) goods to protect domestic industries from "dumping". In March 2001, all zero-rated imports were replaced by a 5 percent duty rate as part of a revenue raising measure.

The level of protective tariff is in reality much higher than implied by the structure since taxes are computed

on the duty-inclusive value of the import. As a result, the overall tax rate can be as high as 60 percent and over in some cases.

Although as of 2000, Ghana's simple average tariff rate of 12.2 was significantly lower than the average for ECOWAS (18 percent), actual taxes collected as a percentage of the total value of imports amounted to 7.1 percent. The key explanation for this trend is that the current system has an extensive zero-rating component and a significant number of exemptions, particularly on intermediate raw materials and capital goods. In 2000, over 22 percent of imports were admitted exempt from import duty. Presumably, the objective is to lower the domestic cost of production and thereby encourage the development of local industries. However, the impact of such exemptions on effective protection rates and the consistency of such protection with the country's implicit trade strategy, are not obvious and need to be studied.

Exemptions in Ghana fall under three categories. The first category of exemptions are provided in Parts A and B of the Third Schedule of the Customs, Excise and Preventive Service Act, 1994 (Act 476). Part A of this schedule specifies persons, institutions or organizations exempted from payment of import duties (e.g., Government, Privileged Persons, Organizations and Institutions). Part B provides general exemptions for certain goods, and in some cases certain types of uses[1].

The second category provides temporary exemptions from import duties for goods in Bonded Warehouses and Free Trade Zones as long as goods produced or stored in such premises remain in these locations. However, if the goods are re-exported directly or indirectly as inputs in production of exported goods, they become liable for duties.

[1] These are advertising materials; aircraft parts and accessories, passengers' personal baggage and effects, educational, cultural, and scientific materials; W. Africa raw foodstuffs and fish caught by Ghanaian vessels, fishing gear, infants' foods, machinery and equipment for agriculture, chemicals for agriculture; jute bags imported by COCOBOD; gifts of a charitable nature, and packing materials for export bearing the company's logo.

The third form of exemptions provides special tariff treatment for certain approved importers or producers. They comprise imports by manufacturers approved by the Commissioner, and imports by enterprises under the Ghana Investment Promotion Act, 1994 (Act 478). Manufacturers may also apply for exemptions under this category by applying to the Commissioner of Customs. This category of exemptions places too much discretionary power in the hands of the Commissioner. This aspect of the law must be revised.

Among the Third Schedule exemptions, the Minerals Commission and the Ministry of Finance account for the bulk of the exemptions[2]. However, imported goods in bonded warehouses constituted the single largest source of exemptions in Ghana in 1998 (34.6 percent of exempt imports).

Issues

As highlighted above, an issue with the present tariff structure is that exemptions allow for too much discretion on the part of the Commissioner. Section II [1] of the Customs and Excise Law states that "... *the Commissioner MAY grant exemptions from customs duty for specified imports in respect of approved projects in manufacturing* ..." The word MAY is ambiguous and allows for discretionary power on the part of the Commissioner. This creates opportunity for abuse and corruption, and the promotion of inefficient firms at the expense of more competitive ones.

Furthermore, due to capacity constraints in monitoring, exempted items tend to be misapplied. This is particularly relevant for products that can serve multiple uses. Exempting them for a specified use does not prevent the exempted good from being applied to an alternative use. This can unfairly disadvantage domestic competitors.

[2] These exemptions apply to imports of line ministries which the MoF neither initiates nor benefits from directly.

Supervision, monitoring and accounting for exemptions granted through the MoF is weak since the MoF does not have a database for exemptions granted to each line ministry. As a result, CEPS lumps all the exemptions under the MoF. With no data available, the MoF cannot and does not account for or report exemptions to Cabinet, Parliament or the public. This makes review of the system virtually impossible, and consequently leaves it open to abuse.

There is therefore a need for MoF to develop a database of exemptions by line ministry. In addition, line ministries must budget for all their tax requirements. Where they exceed their budget, a supplementary budget must be sought and granted, based on merit. Seeking parliamentary exemptions must be discouraged.

Moreover, largely due to the number of exemptions, the tariff structure is characterized by wide ***variations in the level of effective protection***, ranging from a low of 8% for electrical products to a high of 72% for the food processing industry. In addition to wood processing, textile garments and furniture, food processing is considered a priority area for industrial development.

In this respect, it is important to continually assess these so-called industry clusters to determine whether their effective rates of protection are adequate or appropriate in the context of their performance.

The productivity and efficiency of firms in the high priority clusters must be continually monitored, and poorly performing firms must lose their preferential status. Furthermore, the overall level of protection for such firms must be continually assessed to determine whether the protection enjoyed is excessive or appropriate.

Studies reveal that records of goods cleared out of bonded warehouses in Accra, which accounts for about 73 percent of bonded warehouses, are poor. This makes it difficult to track the destination of the majority of imports that enjoy temporary exemption into warehouses. In 1998 only 23.7 percent of goods entered into warehouses and free zones were accounted for in the ASYCUDA database.

In response to abuses of the bonded warehouse system, CEPS now requires that entries into warehouses must be applied for on a consignment-by-consignment basis. The result has been long delays in granting permission for such entries, and consequently, high and unnecessary port and storage charges. However, the measures have not addressed the fundamental problem of leakages since the current system of physical control and monitoring appears to be operationally ineffective.

Abolish the consignment system currently in place and replace the manual system of recording transactions with a computerized system (especially in Jamestown). Improve security with respect to movements of goods from warehouse to warehouse.

The majority of goods passing through bonded warehouses appear to be consumer goods and finished products, implying that bonded warehouses are mainly used by traders for delaying import duty payments, rather than manufacturing under bond for export or domestic sales. Of the 200 bonded warehouses in Jamestown, only 23 are for raw materials, the rest are for general goods.

To discourage this practice, the annual license fee must vary with the type of commodity stored in the warehouse. Finished products must attract a significantly higher fee than raw materials. To ensure that the real value of the fee is realistic, it must be expressed as a dollar equivalent.

Free Zones, if designed and managed efficiently, can be an important vehicle for boosting Ghana's manufactured exports trade by providing a low-cost environment for domestic and foreign investors to operate. However, it is reported that the vast majority of free zone enterprises currently licensed or in operation are mere trading companies with little or no value addition. The extremely generous income tax incentives for zone operators, coupled with weak enforcement and monitoring mechanisms to ensure compliance with the spirit of the Free Zones Act of 1995 (i.e. the promotion of export manufacturing), has contributed largely to this trend. Furthermore, issues of poor monitoring and control are even more

pronounced for Free Trade Zones than for bonded warehouses. This is particularly the case for so-called Free Zone Enterprises since such firms enjoy the exemptions associated with a FTZ, but are not required to locate in a Free Trade Zone.

Discourage the establishment of free zone enterprises. Restructure the incentive system to penalize low value addition firms and reward high value addition firms.

The use of exemptions from import duties on capital equipment and/or raw material inputs as a tax incentive to attract foreign and domestic industry, must be revisited in the light of international best experiences which indicate that such incentives rank low in the priorities of investors in making investment decisions. Political stability, macro-stability and good infrastructure have been shown to be more effective incentives to investment. In this connection, the recent commitment in the 2001 Budget by government to limit the tax holiday provided under GIPC Law, Act 478 to no more than 10 years, is a step in the right direction.

In general, poor monitoring and control of exemption programs can undermine domestic competitiveness and export growth as a result of one or a combination of the following:

- Ineligible firms enjoy exemptions and unfavorably compete with more efficient firms; this breeds a crop of inefficient firms and destroys the more efficient firms
- Leakage of bonded warehouse imports into the local market can unfairly undermine the competitiveness of producers of import competing products

The extensive use of exemptions may be due to the operational constraints associated with the *duty drawback scheme*. The procedures governing the system tend to be slow and cumbersome, and it is reported that in some cases the minimum time required to process a claim is 3 to 4 months. As an alternative, firms that are not reimbursed by the deadline, must be able to offset their reimbursements against their tax liabilities.

To promote domestic industry, priority should be given to lowering the tax liability of importers of raw materials and intermediate inputs used in the production of manufactured exports. However, there are some operational difficulties in distinguishing inputs from finished goods. Some finished products such as air conditioners also constitute inputs in the production of other commodities. The definitions of inputs and raw materials must be clarified to avoid unduly penalizing exporters.

Exchange Rate Policy

Another key aspect of trade policy is the exchange rate. Ghana moved from a fixed to a flexible exchange rate policy as part of its trade policy reform. Following the introduction of the flexible rate regime, the exchange rate has with the exception of brief interludes of stability, experienced excessive nominal and real variations in its value. Exchange rate variability has also been coupled with periods of real appreciation as evidenced by the resurgence of the parallel market in recent times. Accelerated inflation in Ghana relative to her trading partners and administrative interventions in setting the exchange rate, have both contributed to the real appreciation of the exchange rate.

Issues

Exchange Rate Variability and Overvaluation

Real appreciation, coupled with the variability in the nominal and real exchange rates, can have a negative impact on exports, foreign direct investment and the competitiveness of domestic producers.

The real appreciation of the exchange rate implicitly taxes the incomes of exporters because it lowers the cedi equivalent of a unit of foreign currency earned. If exporters have no recourse but to exchange the earned income at the overvalued official rate, they suffer a potential income loss.

On net basis, firms engaged in the production of import competing products also suffer from an overvalued exchange rate because, even though overvaluation raises the domestic currency price of their imported inputs, this benefit is more than offset

by the lower domestic currency price of competing final imports. The reason is that, unlike final or finished imports, the import content of domestically produced goods is less than 100 percent.

The combined effect of real exchange rate appreciation and variability is lower private sector investments in both the export and import competing sectors of the economy. Productive investments will tend to be replaced by investments in unproductive activities such as currency speculation, and trading in the relatively cheaper imported finished goods.

Real currency appreciation or the overvaluation of a currency also ***erodes the level of effective protection offered to domestic*** firms because it invariably reduces the domestic currency price of imports, thereby negating the potential import price increase induced by the tariff. Hence, a tariff structure designed to promote domestic industry will be undermined by a policy (conscious or deliberate) of exchange rate overvaluation. At the same time, by effectively reducing the cost of imported inputs, a real appreciation shifts demand away from domestic input substitutes and in favor of imported inputs.

In addition to draining the foreign currency reserves of the nation, real appreciation ***reduces the potential for downstream linkages among domestic producers***, and compromises the domestic employment generating impact of domestic production. Linkages are reduced because it is cheaper for producers to buy their inputs from abroad than from domestic suppliers

On the other hand, an unstable exchange rate introduces uncertainty in the calculations of domestic and foreign investors. Domestic investors may have to hold larger inventories of imported inputs than necessary in anticipation of unfavorable exchange rate trends. Foreign investors may find their profits eroded by massive depreciations in the currency.

Indeed, studies reveal that ***real exchange rate stability is critical for manufactured export growth.*** High manufactured export/GDP ratios of 20 percent or more were found to be associated with exchange rate stability in countries such as Thailand, Tunisia, Republic of Korea, Mauritius and Malaysia. Only a few countries with ratios below 10 percent achieved real exchange rate stability. Ghana was not one of them. Hence, the performance of Ghana's manufactured exports can be improved through the pursuit of sound fiscal and monetary policies that minimize real exchange rate variability. In turn, by boosting investor confidence, currency stability can favorably impact on manufactured exports.

Indeed, membership of a fully functional West African Monetary Zone and the realization of a common currency could help stem the currency variability plaguing Ghana and other Sub-Saharan countries. This would however, require a credible commitment to satisfying the criteria for membership of the Second Monetary Zone.

Transactions Costs and Domestic Competitiveness

Poor and unreliable communication systems, administrative delays, and bribery contribute to rising transactions costs in Ghana. In turn, such costs constitute a significant constraint to manufactured export growth. A study of East Asian and Sub-Saharan African countries revealed that transactions costs accounted for the large differential in the average manufacturing exports to GDP ratios of Indonesia, Malaysia, the Republic of Korea and Thailand on the one hand, and Sub-Saharan Africa on the other. In 1990 the manufacturing export to GDP ratio for East Asian countries was ten times higher than for Sub-Saharan Africa.

Summary and Policy Recommendations

Ghana's drive to attain international competitiveness must be based on a coherent trade strategy that must be one component of a comprehensive industrial policy. It is estimated that the aggregate growth rates induced by industrial policy in Korea was approximately half of 1 percent a year. Japan and Korea generated higher growth rates than countries pursuing a purely import substitution industrialization approach by inducing significant competition, either by holding "contests" as in Japan (Stiglitz 1996) or by linking preferential interest rates and tariffs on

imported goods to success in export markets, as in Korea. Firms thus had strong incentives to improve productivity.

If Ghana is to extract similar benefits from industrial policy that Japan and Korea obtained, it has to develop not only an exceptionally capable bureaucracy, but also the political ability to withdraw benefits from non-performing firms.

This brief identifies the following key issues to be pertinent with respect to trade reform and liberalization:

- Trade reform must be embedded in the context of multilateral and regional trade agreements such as WTO, EU-ACP and AGOA
- Capacity and domestic production constraints militate against maximum exploitation of preferential trade arrangements as provided under AGOA and EU-ACP
- Prior to the roll-back of preferential trade opportunities in 2007, a strategy of partnering foreign firms should be pursued
- In the long run (after 2007) domestic firms must position themselves to compete within the context of the WTO free trade regime
- This would require an enabling strategic trade policy environment and a commitment to addressing the issues identified below

Recommendations

Formulate a Comprehensive Trade Policy Document

There is need for a coherent trade policy outlining how the government proposes to promote the competitiveness of domestic firms and to diversify the export base of the economy. The trade policy must be part of an overall industrial policy aimed at increasing the relative contribution of industry to the GDP.

Monitor and Review Effective Rates of Protection in the Context of the Real Exchange Rate

Tariffs must be used strategically to promote industries identified as strategic within the context of a Strategic Trade Policy. In this context, there is the need to monitor and review the effective rates of protection for strategic and non-strategic firms, to assess the effectiveness of the tariff structure in achieving the nation's trade policy objective. Current emphasis has been on reviewing nominal rates of protection, with little attention being paid to the real exchange rate.

Accommodate Non-Statutory Exemptions in Existing Tariff Structure

The use of exemptions must be restricted to statutory cases only. To a large extent, preferential treatment for specified commodities should be accommodated within the current tariff structure.

Consistent with the government policy of streamlining the system of exemptions, the 2001 Budget Statement restricted exemptions under the Mining List to plant, machinery and equipment. In addition, items of a charitable nature imported by NGOs are only tax exempt if they are health- or education-related products. However, most of the exempted items should be zero- rated to remove the element of discretion.

Reduce the Commissioner's Scope for Discretionary Exemptions

Section 11 [1] of the Customs and Excise Law must be re-phrased to limit the Commissioner's discretionary powers of exemption. The word MAY must be changed to SHOULD.

Free Trade Zones: Tie Incentives to Degree of Value Addition

To ensure that manufacturing activity in FTZs is significant and not merely trivial, the minimum amount

of value addition required to qualify for FTZ status needs to be clarified. The minimum value addition required for FTZ eligibility must be expressed as a percentage of the value of the final product. Furthermore, the incentive structure must be tied to the relative share of value addition and the components of value addition. For instance, firms that use a greater proportion of domestic inputs (besides utilities) must receive greater incentives.

Free Trade Zones: Discourage Free Zone Enterprises

Given the current constraints with respect to monitoring, free zone enterprises must be discouraged or be required to locate in FTZs.

Bonded Warehouses: Improve the monitoring system and use a tiered (dollar equivalent) license fee system to discourage non-manufacturing oriented use of warehouses.

Duty Drawback Scheme: Credit delayed refunds against VAT and other tax liabilities of eligible importers

Delays in processing duty drawback refunds are a disincentive to export promotion. In the event of a delay, firms must be allowed to credit such refunds plus interest against their VAT and other liabilities. Interest payments are particularly necessary in the current environment of high inflation and nominal currency depreciation.

Alternatively, the import duty paid could be placed in an escrow account in a designated bank which would expedite the release of such funds upon satisfying the terms on which the refunds are granted. This avoids the tendency for such funds to be spent in the interim.

Another alternative is to abolish the system altogether and allow duty-free imports by exporters. However, a sample of qualifying firms should be periodically audited as part of the tax monitoring process, to verify the legitimate use of such imported inputs. Once again, this would encourage proper record keeping on the part of producers, and help promote a culture of tax compliance. The carrot would be the duty-free import; the stick would be stiff penalties for abusing the system and the proper record keeping to prove compliance with the law. The success of this strategy of course, hinges on an effective Internal Revenue Service.

Promote Currency Stability and Avoid Currency Overvaluation through fiscal restraint

To achieve currency stability, government must maintain fiscal and monetary discipline to lower inflation and interest rates.

Adopt a transparent and credible exchange rate policy

Attempts to stabilize the nominal exchange rate through administrative controls and or interventions on the currency market, have proved unsustainable and magnified subsequent nominal depreciations of the currency. The Bank of Ghana's current policy of price stability, if achieved, is consistent with stability of the real exchange rate. After failing to achieve price stability, the Bank has resorted in the past to manipulation of the exchange rate. There is thus, a need for a credible and transparent foreign exchange policy to reduce uncertainty in the minds of investors.

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