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To What Extent Do EU Tariff Preferences Benefit Apparel Exporters from Bangladesh? Exploring Implications for Post-LDC Competitiveness

*Mohammad Abdur Razzaque and Syful Islam**

Abstract: How tariff preferences impact the competitiveness of Bangladeshi apparel exporters constitutes an important issue, considering the country's impending graduation from LDC status. This policy brief uses the concept of 'tariff pass-through' to explore how preferences translate into real benefits for exporters, such as obtaining higher prices for their products, and the consequent implications for maintaining market competitiveness post-LDC graduation. Evidence from various studies shows that the extent of benefit from preferences accrued to beneficiary country exporters varies widely. Given the data limitations, while direct econometric estimation is not possible, it can be inferred that Bangladeshi exporters could gain a price premium of 0.5 to 0.8 for every unit of EU MFN tariff. That is, given the EU MFN tariff rate of about 12 per cent for apparel products, Bangladeshi exporters could have benefited by 6 per cent to 9.6 per cent as a price advantage due to receiving duty-free market access. The impending shift to full MFN rates post-graduation, therefore, poses a risk of eroding these benefits, potentially affecting competitiveness. As the preference pass-through is less than full, estimates of potential export losses due to LDC graduation, as undertaken in many different studies, could be exaggerated. Nevertheless, any sizeable benefit from the existing tariff preference will call for strategies to mitigate any adverse effects due to the withdrawal of preferences triggered by LDC graduation. Improving product quality, moving up the value chain, strengthening backward linkages, and tackling the high cost of doing business are among the factors that can help improve competitiveness in the face of loss of LDC status. Proactive engagements with the EU, seeking more favourable terms in the EU's revised GSP framework to maintain or protract duty-free access beyond LDC graduation, can also help with competitive market positioning.

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* The authors are respectively, Chairman, Research and Policy Integration for Development (RAPID) and Research Associate, RAPID. Any views expressed and/or limitations associated with this article are those of the authors, and in no way should not be attributable to the Foreign, Commonwealth and Development Office (FCDO) of the UK.

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I. Introduction

Evaluating the impact of an importing country's tariff preferences on exports from other countries involves assessing the extent to which tariff reductions translate into real benefits for exporters, such as obtaining higher prices for their products. The concept of 'tariff pass-through' is usually employed to indicate how much of a tariff incidence falls on the final price of imported goods. When the incidence is fully passed through, prices for the consumers are increased by the full extent of the tariff amount. The pass-through can also be partial in nature in which case part of the tariff cost is borne by the consumers with the rest absorbed by those in the supply chain. Conversely, tariff preference pass-through relates to the effect of reduced tariffs, granted as preferences to certain countries or products, on final prices. It assesses whether the benefits of these lower tariffs reach consumers as lower prices or are captured by importers or exporters. It is also possible for the preference rent to be distributed between exporters and importers only bypassing the consumers altogether. The degree of pass-through depends on various factors such as the market structure, the nature of competition, and the elasticity of demand and supply.

Understanding the magnitude of tariff preference pass-through is important for several reasons. It helps determine how much of the cost advantage from tariff preferences is reflected in export prices. If a significant portion of the preference is passed through to importers or consumers (resulting in lower export prices net of tariff), exporters may rely heavily on this cost advantage to compete in the preference-granting market. The withdrawal of preferences could erode this competitive edge, necessitating adjustments in pricing strategies without compromising market position. Understanding pass-through dynamics also equips exporters with insights into their ability to absorb tariff hikes if preferences are withdrawn. When the pass-through is high, exporters might need to find ways to reduce costs or enhance product value to maintain competitiveness. Conversely, if the pass-through has been low, it may indicate that exporters have some cushion to absorb tariff increases without immediate drastic impacts on prices. Furthermore, as exporters' competitiveness is not solely determined by prices but also by how quickly and effectively they can adapt to changing market conditions, the knowledge of pass-through mechanisms allows insights into the market dynamics at play, enabling exporters to anticipate and respond to shifts in consumer demand, pricing sensitivity, and competitive pressures resulting from policy changes.

Bangladesh has been the largest beneficiary of the EU's Least Developed Countries (LDC) tariff preference. By leveraging the EU's Everything But Arms (EBA) initiative, which offers duty-free and quota-free access to products from LDCs, Bangladesh's exports to the EU increased from $2 billion in 2000–01 to $25.2 billion in 2022–23. European markets (including the UK) account for over 80 per cent of Bangladesh's trade preferences, making them the primary source of preferential trade benefits. However, Bangladesh's impending graduation from the LDC status in 2026 could result in losing EBA duty-free market access for apparel products by 2029. If Bangladesh has benefited from the EU by converting its tariff-preference rent into higher prices, it will likely need to make significant adjustments to its post-tariff prices to remain competitive in the EU market. Conversely, the required adjustments could be smaller if the EU significantly benefits from the tariff pass-through of preference by paying a lower import price to Bangladesh.

Several studies indicate considerable export losses for Bangladesh due to post-LDC tariff hikes (e.g., WTO, 2020). However, these export losses could be overestimated without understanding the actual preference pass-through to EU import prices. Despite studies highlighting the potential impact of tariff preference erosion on export competitiveness, the critical issue of the magnitude of preference pass-through has not been given due consideration. This policy brief addresses the issue to provide further insights into the impact of LDC graduation on Bangladesh's apparel export competitiveness in the EU.

II. Evidence on tariff pass-through from the literature

One of the most prominent earlier study on how tariff impact export prices is due to Feenstra (1987), who estimated that, on average, the tariff pass-through for Japanese cars and heavy cycles were 0.6 and 1 per cent respectively. Ahmad & Ahmad (2023) found complete tariff pass-through to the import price of steel in the US in both the short and long run.

Olarreaga & Özden (2005) and Özden & Sharma (2006) analysed the pass-through for unilateral trade preference provided by the USA. Most of the pass-through estimated is incomplete with the importer capturing the larger share of the rent. Both studies investigated the tariff pass-through for apparel exports to the US. Olarreaga and Özden (2005) found that The African Growth and Opportunity Act (AGOA) apparel exporters capture only 30 per cent of the preferential tariff rent from the US market. They showed that AGOA beneficiary countries had captured less preference rent because of higher levels of importer market power. This effect is more pronounced for exports with lower export volume and for products with lower tariff rates. In the cases of Caribbean Basin Initiative (CBI) apparel exporting countries, Özden & Sharma (2006) find a considerably higher (64.7%) level of the preferential tariff rent being captured by the exporters. Both Olarreaga & Özden (2005) and Özden & Sharma (2006) find results indicating that larger exporting countries tend to capture a greater share of the rent. Considering this fact, Benedictow and Boug (2013) accounted for varying import prices from high-cost countries to low-cost countries, especially China, in their model and found that, on average, international price impulse has reduced by 2 percentage points per year since 1990.[1] This implies that China's impact on the clothing industry has been significant. Benedictow & Boug (2013) estimated that the tariff pass-through is 0.44 in the Norwegian apparel market, meaning that as high as 56 per cent of tariff adjustments were borne by Norwegian importers.

Similarly, Cirera (2014) and Cirera and Alfieri (2012) estimated the tariff pass-through for unilateral trade preference provided by the EU. Cirera and Alfieri (2012) analysed a group of products that are

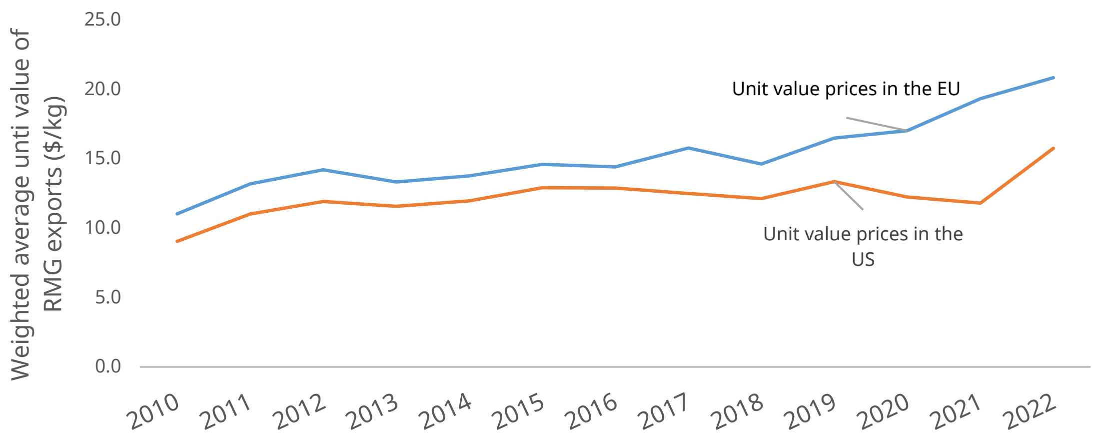
[1] The international price impulses represent the influence of global price movements on the prices of imported goods.

frequently exported to the EU. For this group of products, an incomplete pass-through in the range 0.4-0.6 was observed. Cirera (2014), on the other hand, found that the pass-through differs for products with a tariff margin higher than 4 per cent and those that are differentiated. He estimated that the extent of pass-through is between 0.48 and 0.59 when the tariff margin exceeded 4 per cent. Moreover, when tariff margin exceeded by 4 per cent as well as product is differentiated, the pass-through ranged from 0.68 to 0.8. This non-linearity in pass-through is also confirmed by Hayakawa & Ito (2015) who used a global dataset.

III. Drawing inferences about Bangladesh from other Studies

No study has exclusively focused on assessing the tariff preference pass-through for Bangladeshi exporters. Curran and Nadvi (2015) analysed nine garment products and found that between 2010 and 2013, Bangladesh secured higher unit prices in the EU compared to the US market. This would suggest that the tariff preferences in the EU, unlike in the United States, might have allowed Bangladesh to command higher prices, potentially buoyed by the preference rent. Extending this analysis to include all Ready-Made Garment (RMG) products exported from Bangladesh and more recent years, as conducted in this policy brief, a similar trend is observed (Figure 1).

Figure 1: Bangladesh's weighted average unit value prices of RMG exports to EU and US markets



Source: Authors' analysis using EU-Comext and ITC database

A direct estimation of pass-through for Bangladesh remains a challenge. Bangladesh has always received tariff preferences in the EU, while it never received any such preference for textile and clothing items in the United States. Consequently, there are no variations in tariff rates, making it empirically infeasible to estimate the preference pass-through. Therefore, this paper uses the findings from the literature on other countries, a summary of which can be found in Table 1, to draw inferences for Bangladesh.

Table 1 clearly shows that tariff pass-through varies significantly. While some evidence suggests a complete pass-through of tariffs to domestic prices (Feenstra, 1987; Ahmed and Ahmed, 2023), the pass-through of tariff preferences to exporters is typically incomplete. For Bangladesh, the preference pass-through could closely mirror the scenario described in Cirera (2014), where countries with a tariff margin higher than 4 per cent were evaluated. In the EU, Bangladesh benefits from a preferential tariff margin of between 9 per cent and 12 per cent.

Table 1: Estimated tariff-pass through for unilateral preference, MFN, RTA

Source	Importer	Exporters/conditions explored	Estimated tariff pass-through (exporter's Share)
Olarreaga and Özden (2005)	US	AGOA	0.3 (Apparel)
Özden and Sharma (2006)	US	CBI	0.647 (Apparel)
Cirera (2014)	EU	Tariff margin > 4%	0.48 - 0.59
	EU	Tariff margin > 4% + Differentiated Product	0.68 – 0.8
Cirera and Alfieri (2012)	EU	Product Group	0.4 - 0.6
Anthony N. Rezitis and Brown (1999)	US	Greek, Turkey	0.185 (Tobacco)
	Tariff Pass-through for MFN		
Feenstra (1987)	US	Japan	0.6 (cars) 1 (heavy cycles)
Ahmad and Ahmad (2023**)**	US	World	1 (Steel)
Hayakawa and Ito (2015)	World	World	0.727 (RTA) 0.282 (MFN)

Note: AGOA stands for The African Growth and Opportunity Act (of the United States) under which many economies of sub-Saharan Africa receive preferential market access in the USA. CBI indicates the Caribbean Basin Initiative, enacted by the United States to provide several tariff and trade benefits to some Central American and Caribbean countries.

IV. Policy Implications

The most plausible estimates, as available in the literature, would suggest that Bangladeshi exporters can net a price premium of 6 (12x0.5) per cent to 9.6 (12x0.8) per cent over the EU's Most MFN average tariff rate of 12 per cent, with the remainder benefiting EU importers or consumers. Post-LDC graduation, facing the full MFN rate would result in tariff increases per unit of 6 per cent for a pass-through of 0.5 and 9.6 per cent for a pass-through of 0.8, indicating higher risks of tariff hikes with greater pass-through rates.

Research, including by Razzaque and Rahman (2020), United Nations (2016) and WTO (2020), has predicted potential export losses due to tariff hikes post-LDC graduation, implicitly assuming full preference utilisation and rent capture by Bangladeshi exporters. However, with an incomplete pass-through of 0.5 to 0.8, these losses might be less severe than anticipated. For instance, using a partial equilibrium analysis with 2015-17 data, Razzaque and Rahman estimated a potential export loss in the RMG sector of $2 billion. This potential loss decreases to between $1 billion and $1.6 billion for pass-through rates of 0.5 to 0.8, respectively.

The outcome will vary based on the importer's market power and their willingness to reduce their preference share. If the importer will retain their profit due to the tariff rent, Bangladesh will need to lower its prices by the full extent of tariff rise post-graduation. It has been found that Bangladesh's apparel exports have a high own-price elasticity of more than 3 in absolute terms and a low markup around 4 per cent (Razzaque et al. 2023). This indicates that the room for absorbing tariff shocks could be quite low.

Therefore, to mitigate the impact of tariff increases post-LDC graduation, Bangladesh should proactively aim to increase its markup in the EU. One way of achieving this is to enhance product quality and move into the high-value items. Improving product quality will not only justify higher markup rates but also strengthen market competitiveness. Investing in research and development, fostering innovation, and aligning products with evolving consumer preferences are critical steps in this direction. Additionally, working closely with brands can help ensure the vertical movements into global value chain.

Strengthening backward linkages comprise another means of producing higher quality products at lower costs, thereby enhancing competitiveness in apparel exports. By expanding both cotton and non-cotton fabric production, in particular, Bangladesh can not only improve its export capabilities but also boost diversification within the textile sector. Investing in this sector should focus on supporting export-oriented production that does not rely on tariff protection for backward linkage units. Such strategic investments will help mitigate the challenges posed by increased tariff rates following LDC graduation and elevate markups and profitability.

Addressing the high costs of doing business can also significantly enhance competitiveness and help exporters recoup losses incurred from diminishing foreign tariff preferences. This can be achieved by adopting cost-effective advanced technologies, employing a skilled workforce, and reducing lead times. Additionally, sourcing lower cost imported raw materials and implementing robust supply chain management strategies will decrease production costs and improve overall efficiency.

Finally, LDC graduation does not necessarily imply the end of tariff preferences, and extending these preferences beyond graduation can help maintain a competitive market position. Even after its LDC graduation, Bangladesh has the opportunity to preserve duty-free access to the EU market under the GSP+ scheme, contingent on meeting specific criteria. Although Bangladesh meets the vulnerability criteria required for GSP+ eligibility due to its non-diversified export base, it must also adhere to 32 international conventions covering human rights, labour rights, environmental protection, and good governance. Securing GSP+ benefits, however, is complicated by Bangladesh’s large share in EU apparel imports, which activates safeguard measures potentially negating these benefits and subjecting apparel exports to the EU's significantly higher MFN tariffs. The EU’s postponement of new GSP regulations until 2027 provides Bangladesh with a crucial opportunity to negotiate better market access conditions and potentially adjust safeguard thresholds that currently restrict its benefits under GSP+.[2] During this period, Bangladesh should proactively align its domestic policies with GSP+ requirements and advocate for more favourable terms in the EU’s revised GSP framework. This proactive engagement is essential for Bangladesh to leverage its export capabilities fully and mitigate any impacts of its transition from LDC status.

[2] Details on this can be found in Razzaque (2024).

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RAPID
Research and Policy Integration for Development

House 18 (Flat 504), Road 101,
Gulshan-2, Dhaka 1212, Bangladesh
+880 1711 287 444
info@rapidbd.org
rapidbd.org