Will Phase-Out of DEPB Spell Disaster for Indian Exports

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The proposed phase-out of DEPB (Duty Entitlement Pass Book) scheme with effect from 30 June this year has rung alarm bells for the Indian exporters. The hue and cry that the exporters have raised was only expected; perhaps even inevitable, for, the exporters have been enjoying its benefits for several years and any withdrawal has to attract a lot of criticism and dark, even presumptuous, prophecies.

The Export Scenario

India Exceeds Export Target for 2010-11

I think any assessment on the need or the absence of DEPB needs to be assessed with reference to our export performance. India’s exports zoomed to an impressive $245.9 billion in 2010-11, registering an increase of 37.6% over its previous year, surpassing the Government’s declared target of $200 billion. Alongside, the imports stood at $351 billion and the trade deficit was at $104.8 billion, which is slightly higher than the provisional forecast of $104.4 billion. In fact, the trade deficit was highest in the month of August for the last 23 months, later moderated on the back of stronger-than-expected exports, which helped narrow the current account deficit in the quarter through December to under 2.5 per cent of gross domestic product (GDP), lower than 4.3 per cent in the previous quarter. Commenting on the export performance, the FIEO President, Ramu S. Deora said that India's diversification strategy is paying off. Asia, Latin American and Africa are the main contributors to this growth and the signing of CECA and FTA with Asian countries is set to raise Asia's share. He, however, expressed his concern over the increasing cost of credit and infrastructural bottlenecks, which may have a bearing on Indian exports in the next couple of years.

But is our export growth sustainable?

Probably, the answer is more no than yes. Exporters fear drastic impact of interest rates rise and the withdrawal of the export promotion, DEPB. Says Ramu S. Deora, President, Fieo, "Growth may taper off from July onwards as the Government has announced its decision to withdraw DEPB. The export credit is also up at 10.75% from 7% in April, 2010."

Dr. Rahul Khullar, Commerce Secretary says uncertainty in Europe and not-too encouraging data about the US economy are areas of concern. "I still remain far from sanguine that 2011 will be good years...hold your horses, let’s see where we go." Concedes Ajay Sahai, Director General, FIEO that the situation in these markets had large implications for India's exports. He, however, says that some of the non-traditional markets such as Latin America and Africa could provide some succor. He adds, "India is aggressively forging trade agreements which will help boosting exports to non-traditional markets."

Concurs D.K. Joshi, Chief Economist, Crisil, "Growth rate should moderate further as external environment is not that conducive to growth with tightening in Asia and advanced markets continuing to remain weak."

Why DEPB?

It may be pertinent to point out that under DEPB scheme, exporters receive duty-free scrips or entitlements, based on the value of good exported that can be used to pay import duties. The Government decides on and declares the rate at which the incentive is to be provided for different export goods. These scrips can be traded freely, making the scheme a favourite with exporters.

Why not DEPB?

The justification for existence and continuation of DEPB scheme needs to be adjudged in the context of the fact that exporters can claim credit for the Excise duty that they pay on the domestic inputs and they also get duty-free scrips, giving them double advantage. Under the drawback, the Government neutralizes levies paid on inputs. The Finance Ministry has proposed to move all the exporters to drawback scheme, which is a duty neutralization scheme.

Without trying to pre-judge the issue, on merit, the credit for bold steps does go to Pranab Mukherjee, an astute Finance Minister, who has a feel of the pulse of what goes on in industry and what is the call of the time. Despite intense industry lobby, the Finance Ministry has announced that it will not give any extension to this popular export incentive scheme. "It will be phased out on June 30. That is the Finance Ministry's decision" declared Revenue Secretary Sunil Mitra. Explaining the basis for such a decision, he said the Government faced an estimated annual revenue loss of ₹8,000 crore currently on account of DEPB, which was first declared in 1997. It may be pointed that the DEPB Scheme had cost the exchequer ₹7,092 crore in 2008-09, which went up to ₹8,027 crore in 2009-10, and has shown a sharp inclination to go further up, since it has already gone up to ₹6,434 crore during April-December 2010 i.e. during first nine months of the current fiscal and is most likely to go up much beyond the 2009-10 figures by the time the current fiscal closes. The Ministry of Finance considers this scheme as a drain of Government revenue. It has been argued by Ministry of Finance that the DEPB scheme allows double benefit to exporters instead of just neutralising levies on inputs. The scrips are provided on the assumption that a number of inputs are imported.

Second, the Government says that there has been a record high of 36.7% increase in exports during 2010-11, which only shows that the exports are on a stable upward course and do not need the prop of DEPB. This, the Finance Ministry says, has further weakened the case for export incentives. Says Mitra, "We really feel that we are rewarding exports on the one hand and losing revenue on the other hand." Adds Commerce Secretary Rahul Khullar that there is merit in the Finance Ministry's argument that when exporters were doing so well, where is the need to continue sustaining them by throwing money at them? He added that the exporters can always draw the tax rebates through other windows like duty drawback scheme.

Third, under the DEPB scheme, the exporters get refund of duties on import content of their export products. The tax refund mechanism is considered to be non-compliant with the World Trade Organisation (WTO) rules so, the Government has been trying to phase-out the scheme for the past few years. DEPB is reckoned to be non-compliant with WTO because the tax refund is not based on actual import content (and hence tax) of the export product but on certain assumptions on that. This allows the importing countries to challenge DEPB and neutralizing the benefit by imposing countervailing duties on imports from India. Not only this renders India's defence of DEPB difficult, but also the advantage of the price edge gets lost to the exporters.

Fourth, the Government has stood on the point by pointing out that the proposed Goods & Services Tax (GST) would take care of the refunds, as has implicitly and explicitly been built into the GST, where the taxes paid at each stage get adjusted in the next stage.

Industry fears

Various industry and trade leaders have asserted that the phase-out of DEPB may lead to the grim possibility of exports dipping to $200 billion in the current year. They say that the Government has set an export target of $312 billion for 2011-12, assuming growth of 26.7% over 2010-11. They point out that the rapid pace of exports may not be possible to be sustained because of rising cost of credit. Says Fieo President, Ramu S. Deora "Cost of funds for exporters has increased by more than half over the past one year, affecting competitiveness." Interest rate export credit has gone to 10.75% from 9% in April, 2010.

Adds K.T. Chacko, Director, Indian Institute of Foreign Trade, "Exporters in China and other significant developing countries have access to credit at much lower rates than in India."

Friendly match between Commerce and Finance ministries

Our Commerce Minister, Anand Sharma has decided to bat for the exporters. He has declared, while he was still at Addis Ababa that he will take up the issue of phase-out of DEPB with Pranab Mukherjee. Making out a case for extension of the popular incentive scheme of DEPB, he said, "I am one who is not subscribing to this view that our exports have reached a stage where we can do away with some of the incentives. I am going to discuss DEPB and interest rates with the Finance Minister (of course, when he comes to Delhi)". In fact, the Commerce Ministry has already sounded the Ministry of Finance for re-introduction of interest rate subvention or discount scheme for category of exporters to make cheaper funds available. As the Ministry of Commerce has already set up a target of $500 billion exports for 2013-14 against $246 billion during 2010-11, it will also take up the issue of continuing with DEPB.

It is not an unusual scene that the Ministry of Commerce has disagreed with the Finance Ministry, but generally, it is the Ministry of Finance that seems to hold the decisive power.

My Analysis

There has been a lot of fire and brim (?) and the exporters lobby seems to have done good work by making the point that with the phase-out of the DEPB, our export surge will collapse and we might even end up with $200 billion exports during the current fiscal against a target of $312 billion. They have raised their demand for continuance of DEPB to a high pitch, forgetting in the process, the logic and the rationale behind their demand. As per the statements issued so far, exporters or for that matter exporters' bodies have failed to make points. Nobody has tried to explain as to how do they think that phase-out of DEPB will spell disaster for Indian exports. I would include in this shouting brigade the Ministry of Commerce and even Minister of Commerce, apart from the most vociferous trade bodies.

On the other hand, the Ministry of Finance seems to have taken a well balanced stand. Nobody has rebutted the arguments advanced by Ministry of Finance. Let us take up the points made by Ministry of Finance one by one.

First, Ministry of Finance feels that the public exchequer is losing some ₹8,000 crore plus every year due to DEPB payments. This amount is likely to even further escalate, if the current figures of DEPB payments are any indication. They question where is the (genuine) need for it. The Ministry of Finance considers this scheme as a drain of Government revenue. It has been argued by Ministry of Finance that the DEPB scheme allows double benefit to exporters instead of just neutralising levies on inputs. The scrips are provided on the assumption that a number of inputs are imported. Nobody can dispute that the exporters are legitimately entitled to make good the payment they have made by way of import duties, which they can always draw through duty drawback route, but claim to DEPB has, to be precise, no direct or proportionate relationship with the import duties the exporters pay for manufacturing export products.

Second, Ministry of Finance says that the export growth has been moving on a stable upward course and does not need the crutches of DEPB. The very fact that despite not-so-encouraging world trade scenario with the major markets not being in the pink of their health, India has been able to achieve an admirable growth of 36.7% over last year, recording a net achievement of $245 billion against the target of $200 billion for the year 2010-11. The export trend for the current fiscal has also been only encouraging. Where is the need and justification for continuing DEPB, the Ministry of Finance asks?

Third, it is well known that DEPB has not been WTO-compliant. This has been the precise reason that the Government had, for quite some time, been thinking of withdrawing DEPB scheme, but has not been able to do so for several reasons, including the unsure and uncertain behaviour of Indian exports. Now that the shaky export growth has been replaced by a definite surge on a sustainable basis, the Government should not miss out the opportunity to phase out DEPB. It is important to point out that DEPB is reckoned to be non-compliant with WTO because the tax refund is not based on actual import content (and hence tax) of the export product but on certain assumptions on that. This allows the importing countries to challenge grant of DEPB and neutralizing its benefit by imposing countervailing duties on imports from India. So, the earlier we get rid of the same, the better.

Fourth, the Government, in this case Ministry of Finance's rationale that in so far as the refund of taxes are concerned, it is built-in in the Goods & Services Tax (GST) cannot be faulted. However, here the exporters and the Ministry of Commerce do have a point. GST, as it seems today, is not likely to be operationalised even by 1 April, 2012. Thus, any phase-out of DEPB before the introduction and opertionalisation of GST would certainly leave some period i.e. 30 June 2011 (the proposed date of phase-out) to the date when GST becomes operational, as the period when the exporters would be without cover either of DEPB and GST. However, even in this scenario, the route of duty drawback will always be open and available. This problem can be best solved by Ministry of Finance ensuring that the duty draw back route should be smooth and not time consuming and sans babugiri.

Fifth, another point that is being made out by Ministry of Commerce and the exporters is that there has been considerable hike in the interest rates, the details of which have already been given above. But, that can hardly be a reason for continuing DEPB. That is a separate issue, which can be rightly emphasized and even insisted upon by exporters and Ministry of Commerce., particularly in view of the fact that most of our competing economies are offering much lower rates of interest than in India, thereby denying Indian exporters level playing field in this regard.

While there is apparently no reason to believe that with the phase-out of DEPB, Indian exports would collapse, I also suggest that Minister of Commerce may be pleased to consider the merit of discontinuing or phase-out of DEPB in the national perspective and see the logic, reason and rationale behind the decision of his senior colleague and Finance Minister, who has an acknowledged level of being seasoned economist and administrator.

Here 'I' refers to author; he shares his comments on the effect of DEPB on Indian Exports