The Determinants of the Domestic Prices of Imports

by

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I: INTRODUCTION

Imports play a key role in the economy of Pakistan, especially since they provide a large share of the nation's industrial raw materials and most of its capital goods. Scarce foreign exchange is rationed and allocated among different types of commodities through an elaborate licensing system. To cope with the needs of the economy there has been liberalisation of imports in recent times. Proposals for further liberalisation and alternative proposals for rationing foreign exchange through an import surcharge system or an exchange auctioning system have also been put forward. But, in the absence of empirical evidence regarding scarcity value of foreign exchange and the domestic prices of imports, the impact of these changes on the import sector and therefrom on the economy could not be definitely estimated. Different assumptions have been made regarding these magnitudes resulting in very different conclusions about the impact of various policies. A study of the facts is necessary under these circumstances, and so we have embarked on an empirical study regarding the determinants of the domestic prices of imports.

The import sector in Pakistan is subject to many government policies. In addition to the direct controls regarding import licensing and the exchange rate, a detailed tariff and sales tax structure, along with numerous minor regulations, are operative in this sector. Some of the effects of this elaborate system of government policies are reflected in the level and structure of prices of imported goods in local markets. In the absence of import restriction and under perfectly competitive market conditions the domestic price of an imported commodity

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would equal the c.i.f. cost *plus* import duty and sales tax *plus* "normal" competitive mark-up[1]. But the restriction of imports through the licensing system causes excess demand at such a price, and the gap between actual internal price and landed cost is widened. This gap constitutes a licence-created profit for licence-holders. The basic hypothesis under investigation in this paper is that when there is direct control of supply, the main determinant of the local prices of imports at the margin is the import control policy, not the landed costs[2].

In Section II we shall give a brief summary of the present import control policy. Section III gives the purpose of the study along with a theoretical discussion. Empirical findings have been presented in Section IV. The problems of allocation of resources and distribution of income *vis-a-vis* import control policies are discussed in Section V. A summary of the study and a few suggestions about useful investigation are given in Section VI.

II: SUMMARY OF THE LICENSING SYSTEM[3]

Due to the excess demand for foreign exchange, at the existing exchange rate, the government controls almost all imports into Pakistan. A high level Foreign Exchange Committee prepares an annual Foreign Exchange Budget on the basis of expected earnings, aid receipts, and the level of reserves. After the adjustment of the amount of foreign exchange automatically designated for private imports under the Export Bonus Scheme, the committee determines the division of foreign exchange expenditure between private and public imports. The licensing authorities then decide on the commodities to be imported, determine the ceilings for the value of imports of individual items, groups of items, and industries, and allocate the amount earmarked for each item to individual importers. Licences are required for almost all private imports, the major exception being commodities included on the "Free List"[4]. Import licences are issued on a c & f value basis to commercial importers and industrial users and may be used in any country of the world except for items for which specific commodity licences are issued in accordance with trade, aid or loan agreements.

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1 The importers have to pay a few other minor charges, namely, clearance charge, import licence fee, banking charge, wharfage cost, *etc.* We shall use the term 'Landed Costs' for the total of all the costs and charges paid by the importers. Insurance cost is a very small part of the c.i.f. cost and so the difference between c & f and c.i.f. costs is not significant.

2 Actually, of course, price is demand determined under conditions of fixed (controlled) supply. Here we are assuming demand to be excessive and given. Hence, price must be fixed unless there is a change in the controlled supply.

3 For this part of the paper the author draws on [9] which contains a detailed discussion of the import control policy in Pakistan, and on discussions with Dr. Philip S. Thomas.

4 The "Free List" was considerably extended to fifty-one items in June 1964, but for the period in which the commodities considered in the current study were imported, only four items were under "Free List."

The present import policy has its origin in November 1952, in the days of depression in foreign exchange earnings after the Korean boom. Before this system came into operation, private imports were, more or less, free under the Open General Licence (OGL) system (during the period July 1950, to November 1952) under which an importer could import any amount of the commodities under the "OGL XIII" list. With the imposition of the new system, the former Open General Licences were cancelled and each importer of that period was given, for each type of good that he imported, a monetary category the value of which was determined by the average imports during the five OGL shipping periods. A category is a standardized unit of account, the actual value of each licence for a shipping period being expressed as a percentage of the monetary value of the category. For one particular commodity, an importer gets only one category.

With the introduction of the new Open General Licence procedure in 1961, the scope of the category system became narrower. The new OGL applies to specific commodities and to specific groups of commercial importers and provides for issue of licences of specified amounts in each shipping period. Its purpose was to encourage new entrants to the import trade and to extend the value of licences issued in the commodities chosen. Uptil introduction of the "Free List" the new OGL was the principal sign of "liberal" import policy.

Other import procedures exist for certain groups of commodities and industries. Under the "Automatic" licensing procedure, importers of the specified commodities become entitled to another allocation in the same import period under the same licence when an earlier allocation has been utilized.

For industrial raw materials and spare parts, "regular industrial licences" are issued to the quota-holders enumerated by a survey of industrial units. The values licensed are determined on the basis of assessment certificates, issued by Provincial Directorates of Industries, indicating the "requirements" of a quota-holder for raw materials and spare parts to operate on a single-shift basis. Licences for importing machinery for new industrial capacity in the country are based on the sanctions made by the Central Permissions Committee in the Ministry of Industries.

Import licences are also issued under the Export Bonus Scheme on the basis of import bonus vouchers issued by the State Bank of Pakistan to exporters for a specified part of their foreign exchange earnings. Import bonus vouchers are issued for all exports except the exports of some raw material and food items. Imports allowable under bonus vouchers include a wide range of goods specified in the "bonus list" in the import policies. Vouchers are marketable and, due to the excess demand for import, command a high premium.

III: PURPOSE OF THE STUDY AND NATURE OF THE PROBLEM

The main purpose of our study is to find out the extent to which this elaborate licensing system influences the domestic prices of imports. The knowledge of the extent of the licence-created profit, the gap between domestic price and landed cost of an imported commodity, is extremely useful in this context. We should expect the existence of such profit in all commodities since demand is likely to be excessive relative to the controlled supply (otherwise controls are unnecessary and meaningless). The extent of profit, or the differential between landed cost and domestic market price, will vary from commodity to commodity depending on the stringency of licensing of various items. Thus, at the margin, it is the licence-controlled quantity, rather than the landed cost, which determines the domestic market price of imports.

The above hypothesis can be illustrated by the use of a simple supply and demand diagram as shown in Fig. 1. Assuming DD and SS to be the demand and supply schedules for imported goods in domestic markets, we can say that if there were no import restrictions and if competitive market conditions prevailed, amount OX would be imported and the prevailing price would be PX. (The supply curve is drawn horizontal since Pakistan's imports are too small to influence the world price). But if OX_1 is the licensed amount of imports[5], then P_1X_1 will be the prevailing price and P_1L would be the licence-created profit per unit going to the licence-holders. The extent to which a rise in the price to the import licensee, either through an increase in c.i.f. price or an increase in duty or both, can influence the price to the consumer[6], depends partly on the extent of this profit[7]. The price to the consumer can be raised only through a reduction in quantity supplied in the local market. But if a rise in the price to the supplying sector does not affect its "normal" profit[8], quantity supplied in the local market would not be reduced. The profit at the licensed supply may be high enough so that a rise in price to the import licensees (caused by a higher duty, for example) would be absorbed by the importer as a reduction in his profit margin or mark-up. If the rise in landed cost is not large enough to absorb all the "excess" profit or "abnormal" mark-up, the domestic market price is unlikely to change. Suppose a rise in the import duty, a sales tax, or

[5] The government's quotas are, of course, value quotas. However, given foreign prices, value quotas become physical quotas to all intents and purposes. They are so treated in all the diagrams.

[6] "Consumer" here means both the ultimate consumer and the industrial user who buys his raw materials or equipment from the import licensees.

[7] This point has been raised in many recent discussions of which [7] and [8] are the main ones.

[8] The concept of "normal" profit involves a conception of opportunity cost which presupposes the prevalence of competitive conditions. The supply price includes normal profit in our diagrams.

an increased c.i.f. price raises the landed cost so that the supply schedule moves

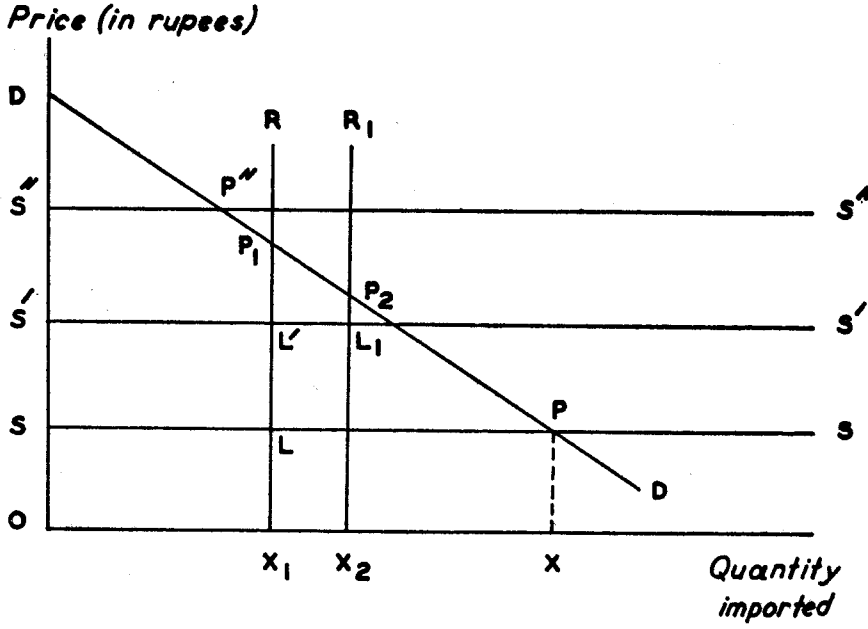

FIGURE : 1 THE EFFECT OF IMPORT RESTRICTIONS

upward to S'S'. With restrictions, the effective supply curve is S'L'R and the market-clearing price is still P_1X_1. The licence-holder still enjoys a profit margin to the extent of P_1L'; the whole amount of the rise in the landed cost is paid out of the former profit of the licensee. But if the rise in the landed cost rises sufficiently the supply curve S''L''R will intersect the demand curve at some point P'' which lies above P, and OS'' will be the price with S''P'' quantity sold. In this (probably extreme) case, the rise in the landed cost is big enough to more than eliminate the licence-created profit, hence the licensees will import less than is allotted to them by the government in the form of licences.

Thus, it is clear that if licence-created profit is large, changes in landed costs should not affect domestic market prices over a fairly wide range. Given domestic demand conditions, changes in domestic price are determined by changes in quantity licensed, not by changes in landed costs over that range. The extent to which landed costs could increase without raising domestic prices is, therefore, related to the licence-created profit of importers, or, roughly, the margin between landed costs and domestic market prices, at any point in time.

The effects of import liberalisation measures, such as the new OGL, the automatic licensing, and the "Free List" can also be illustrated in Fig. 1, as increases in the quantity of a commodity licensed in a particular period. It can also be seen that increased quantities licensed, even if combined with increased

landed costs through regulatory duties, could result in lower domestic market prices. If the licensed amount increased from OX_1 to OX_2 and duties were raised so that the price to the importer rose from SS to S'S', the new supply curve would become $S'L_1R_1$, and the domestic market price would fall from X_1P_1 (under "tight" licensing and lower duty) to X_2P_2 (under "liberal" licensing and higher duty). The result would also be a fall in licence-created profit per unit (or margin over landed cost) from P_1L to P_2L_1.

The empirical study of the licence-created profit margin is extremely important, therefore, in order to analyse the effect of proposed changes in tax structure or import policy, or both, on the domestic prices of imported goods. The extent to which changes in duty or in licensed value of different commodities will effect the internal price structure and thereby influence the allocation of imports can be approximately determined, at least, when the mark-up is known. If for all important commodities under quantitative controls the profit margins are high, existing import duties cannot, and do not, influence relative prices of different imported goods and of imported goods *vis-a-vis* non-imported goods, and they have no allocative role[9]. If, however, there are items priced very close to landed cost, changes in tax rates on those commodities may affect the quantity imported, and, therefore, domestic market prices. The extent of licence-created profit, or existing mark-ups from landed costs to market price, set a rough limit beyond which tax rates on imports will play an allocative role.

The above argument assumes that all users of imported goods purchase such goods from import licensees at the domestic market price. This group includes some industrial users. There is an important class of importers, however, that uses the goods it is licensed to import. These are the industrial importers referred to in Section II, who receive licences to import capital goods, spare parts and raw materials for their own use. A manufacturer possessing import licences buys raw materials and equipment at lower prices and sells the resulting product at prices which fully reflect internal scarcities. "Much of his profit emerges from the spread between world prices and internal prices. His gain is not essentially different from that of the importing merchant who merely resells at high internal prices the same goods he has been licensed to purchase abroad at much lower world market prices" [3, pp. 8-9]. Therefore, though an increase in tax rates would raise the cost to some privileged users of imported raw materials, they would be likely to absorb the increased taxes themselves

9 That the existence of a domestic industry does not alter the argument is shown in Appendix B. However, it is necessary to assume that import licensees are the ultimate users of imports, so that all users face one price: the domestic market price. The reason for this assumption is illustrated in the next paragraph.

in their manufacturing profits, since part of their manufacturing profit is due to possession of scarce import licences.

So far we have discussed the question of profit margin under "quasi-competitive conditions"[10]. It is often argued that there is a considerable degree of monopoly in the licensing of some imported commodities and since there is no free entry into the import trade of category items, the category-holders of a commodity form a group of monopolistic competitors. Therefore, it is suggested that the profits earned in these commodities might be usual monopoly profits and, therefore, placing an item on the "OGL list" might improve the supply position through the introduction of more competition. Now, if the category-holders are monopolistic competitors they may earn greater "abnormal" profits than they would obtain with a "quasi-competitive" market structure.

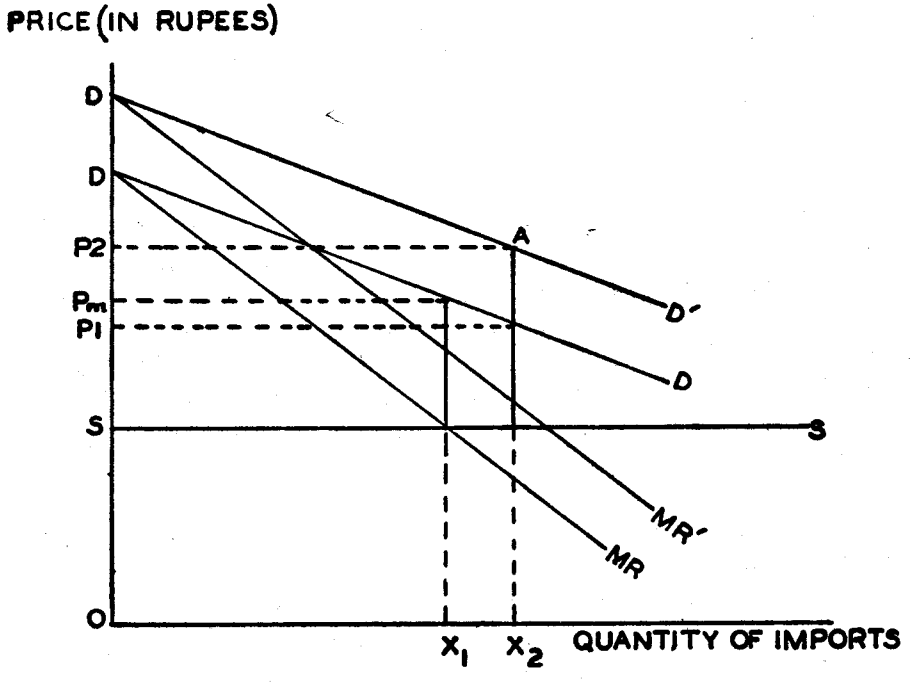

FIGURE: 2 THE EFFECT OF MONOPOLY ON IMPORT PRICES

They would supply the amount determined by the intersection of their marginal cost curves and the marginal revenue curves for the commodity. In Fig. 2, the amount offered for sale by the monopolists will be OX_1 when the demand

10 The conditions of entry, numbers, and collusion have been assumed to be such that a "competitive" pricing situation would prevail if government restrictions were absent.

curve is DD. The government allocation of imports is the quantity OX_2. Since the monopoly-restricted supply falls short of the amount permitted by government allocation, there will be a monopoly profit of SP_m per unit, whereas, under "quasi-competitive" conditions the "licence-created" profit would be SP_1 per unit. However, if D'D' is the demand curve, OP_2 will be the optimum price of monopolist, and it is the "quasi-competitive" price at the same time. The implication of this analysis is that if quotas are not being fully used because of monopolistic restrictions, putting the commodity in the "OGL list" should increase the competition and thereby reduce price somewhat. If all import allocations are utilized however, the domestic prices of imports will not be affected simply by entry of firms. The total profit would be shared by more, of course, but the price would remain the same. If an expansion of the value licensed accompanied the shifting of the commodity to the "OGL list", the supply position would be improved and prices should fall. However, the improvement would be entirely due to the increased foreign exchange allocation, and increasing the number of importers, by itself, could not increase the supply and lower prices.

IV: EMPIRICAL FINDINGS

The empirical analysis of mark-ups above landed cost is based on the findings from samples of "representative"[11] commodities in the three broad groups: consumption goods, raw materials and capital goods. The domestic prices considered are those prevailing in Karachi during the period June-August 1964 and so the import conditions of these commodities are related to the January-June 1964 shipping period[12]. In this section, we first try to analyse the profit margins in these commodities during that period and then attempt to determine the effects of duties on domestic prices of imports.

As has been discussed in the preceding section, the price position may be different for commodities placed under different lists (category or OGL). Some of our samples include commodities imported under more than one list. For the consumption goods the position is relatively clear. Most semi-essentials, luxury commodities, and consumer durables are imported by the category-holders. But in the case of raw materials, no definite division could be made. Here the imports are made by category-holders, by OGL importers, and directly by industrial users.

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[11] *See* Appendix A for a detailed discussion of the samples.

[12] There is usually a lag of two to four months between obtaining of licence and receiving the shipments.

Average Mark-up on Imported Goods

In the consumption-goods group, the average of the profit margins over landed costs in twelve items is 61 per cent, *i.e.*, the "scarcity price" which the consumers have to pay for the imported consumption goods is 61 per cent higher than the landed cost. For most of the items that come under import bonus vouchers the profit margin is as low as 5 to 7 per cent since bonus voucher costs wipe out the scarcity margins to a great extent. Yet the overall difference between landed cost "ex-bonus" and market price still approximates 60 per cent.

For raw materials, in our sample of twenty-five observations, the average profit over landed cost is 58 per cent. The wholesalers in raw materials earn licence-created profit to this extent. The manufacturers who do not have import licences have to purchase these raw materials from the wholesalers at the "scarcity price". The industrial users who get raw materials through industrial licences have lower cost of production than the former, and they, therefore, can earn excess profits. As pointed out above, a part of industrial profits is profit from import licensing, not "real" profits.

Our sample for raw materials is composed of both the "category items" and "OGL items", so it is possible to determine whether or not the price situation is different for the items in the two lists. In our sample, the difference between the average profit margins for "category items" and "OGL items" is 5 percentage points. Since the standard error of the difference between the two means is 9.6 percentage points, the difference is not statistically significant, which means that the average profit rates may not be considered different for items imported under these two types of licence. Even though the "degree of competition" is supposed to be different, the profit margins do not vary significantly. It can be inferred that the licence-restricted supply falls short of the monopolistic maximum-profit quantity, and this supports the view that mere introduction of competition without increased foreign exchange allocation does not improve the domestic price situation.

The existence of some extreme observations in the sample for raw materials necessitated a clear enquiry about their particular supply and demand conditions. Some observations like those of Gum Arabic (8 per cent), *bidi* leaf (260 per cent), lead ingot (108 per cent), and pig iron (15 per cent) are conspicuous by their extreme values. Gum Arabic was in the "Automatic List" in the first shipping period of 1964. The Automatic List is supposed to bring a larger allocation of foreign exchange if it is "needed", which would generally bring the price of the item down. The lower profit margin might be

due to the improvement in supply situation through foreign exchange allocation. Pig iron was on the "Free List". The supply allocation may have been sufficient to cope with the demand at c & f *plus* duty-paid price. There have been some allegations coming from the small importers, regarding the items in the "Free List" that the big importers, in order to eliminate the small competitors, charge a lower price at the outset and when the small importers are out of the market, they raise the prices. Pig iron might be such a case. Of course, it can only be ascertained, if at all, when prices in later periods are examined. *Bidi* leaf is a commodity that the licensing authority tries to license exactly on the basis of "requirements" of individual manufacturers. But the demand for tobacco manufacturers has raised the demand price of raw materials well above the c & f and duty-paid price. Presumably, the domestic market in *bidi* leaves is small and exists only between *bidi* manufacturers in deficit and surplus raw materials positions. A relatively small "error" in foreign exchange allocation can lead to a large internal price change.

For the capital goods our sample was very small. For the sample of ten observations the average profit margin on landed cost was 62 per cent. In order to raise the tempo of industrialization in the country, the rate of duty for these goods is kept low[13]. Low duties were supposed to give incentives for investment. But the high mark-up shows that there is excess demand for capital goods at prices equal to landed costs. While the duties are kept low to encourage imports of capital goods, they are deprived of this role by a licence-restricted supply. The low duties simply add to the profits of the licence-holders. If imports are to be increased, it can be done only through an increased foreign exchange allocation.

One characteristic of some capital goods is that the importers' profit margins are lower for commodities imported from the United States than for the same commodities imported from other countries. This is additional evidence in support of the hypothesis that quantitative restrictions are more important than landed costs in determining (at the margin) domestic market prices. Because, goods from the United States and from other sources are comparable (easily substitutable), their prices in Pakistan's domestic markets are almost the same, while their c & f prices are quite different. Domestic price tends to be set (given domestic demand) by the total amount imported from all sources, not by the cost of the higher-priced US imports that dominate the supply side of the market. Prices to the import licensee are higher due to the higher landed cost of the US items. The profit over lowest landed cost is so high, however, that total quantity imported remaining the same, a rise in price to the importer

[13] *See* [18].

is paid out of licensees' profits and domestic market prices are not affected[14]. Industrial importers using aided imports from the United States pay higher prices than if they were free to use licences to import from other countries. To this extent, there is a reduction in the spread between the prices of domestic manufacturers and their total costs of production, or a reduction in profits.

After finding out the profit margin for different groups of commodities we can give a crude measure of the extent of overvaluation of our currency, assuming that the imports were to be kept at their existing levels[15]. The average scarcity margin is around 60 per cent in all cases. If we subtract 10 to 15 per cent for "normal" mark-ups *plus* costs of distribution, we get the extent of licence-created profit, which is a crude measure of the overvaluation. It comes out as 45 to 50 per cent, which gives support to the prevalent view that Pakistan's currency is overvalued to the extent of 45 to 55 per cent. This implies an exchange rate of approximately Rs. 7.00 to $1.00.

The Relation of Duties to Prices of Imports

In order to test whether duties have any effect on domestic prices we used regression analysis. Our samples are composed of cross-sectional data, since the information is related to one point of time. Different commodities have different rates of duty, and we have computed a profit margin over c & f price for each commodity. When we fit regression equations relating rates of duty to margins over c & f prices, and want to use the coefficients to see whether duties have any effect on internal price, we make the assumption that the 'normal' percentage margin of a commodity with one rate of duty will be the same as that of the commodity with a different rate when the latter rate is imposed on the former commodity. That is, we assume that the difference between international and domestic prices of all commodities vary with rates of duty only. This is a rather unrealistic assumption. When analysing the results of the regression analysis, therefore, we should be careful in rejecting or accepting a hypothesis without reappraising the assumption.

Since the margin over landed cost is high, one would suppose that changes in duties (up to some limit) would be absorbed in this margin. The margin over

14 If dollar loans were not tied to United States exports, of course, a given value loan would provide larger quantities of imports if they could be bought in cheaper markets. It is not clear, however, whether the situation of a tied loan should be compared with an untied loan of the same dollar value or with some other alternative, when assessing "the effects of tied loan".

15 One should be careful in using this, however, since domestic prices for some commodities are from markets that only cover a part of total imports. *Bidi* leaf is an extreme example of such a commodity. If all *bidi* leaf imports were by commercial licence-holders and if all industrial users bid for all of their supplies from commercial importers, a different price would rule than the (black market) price given here (which covers only a small part of total imports). This is probably true in varying degrees for most commodities studied here.

landed cost is likely to change in the opposite direction from the changes in duties, if not by the same amount. The margin over c & f price expressed as a percentage of c & f price includes both the margin over landed cost and the duty. Such a variable will remain constant, more or less, if the changes in the margin over landed costs and changes in duties cancel one another. To examine this hypothesis we fitted regression equations for consumption goods, raw materials, and capital goods separately. The results are given below:

For consumption goods	$Y = 108 + .92X$ $(25) \quad (.30)$	$r^2 = .48$ $N = 12$
For raw materials	$Y = 77 + 1.09X$ $(16) \quad (.39)$	$r^2 = .24$ $N = 25$
For capital goods	$Y = 42 + 2.49X$ $(12) \quad (1.01)$	$r^2 = .44$ $N = 10$

Where $Y = \dfrac{\text{domestic price} - \text{c \& f price}}{\text{c \& f price}}$

X = total duty as a percentage of c & f price.

All the coefficients are significant at 95 per cent level of confidence. The results do not support our hypothesis. The conclusion emerging from these results would be that the internal price might be affected by duties. However, because the profit margin over landed cost is so high, small changes in duties cannot absorb it and a change in supply is unlikely. If the importers try to reduce supply following a rise in duty they will have unused import quotas. But according to the information with the Office of the Chief Controller of Imports and Exports a very small percentage of the quotas are not fully utilized, generally due to reason not related to duty structure.

The regression results may be explained by the fact that the higher the rate of duty, the tighter the licensing is likely to be. Though there is little overt co-ordination between the operation of the Central Board of Revenue and the Chief Controller of Imports and Exports, both these authorities are influenced by the criterion of "essentiality". The less essential a commodity is, the tighter is the licensing and the higher is the rate of duty. There may be at least an un-

conscious coordination between the licensed value and the rate of duty[16]. If the licensing becomes tighter for the commodities which have higher duties, the margin over landed cost remains constant, more or less, for all commodities. Consequently, the margin over c & f price varies with the duty. Therefore, we should not conclude that the duties can affect internal prices when we know that the margin over landed cost is large. The low values of r^2 in all the cases also supports our contention. The duties explain less than 50 per cent of the variation in the margin over c & f price. Though the coefficient of X is significant, only a small part of the variation in Y is explained by X. In case of raw materials, the range of duties is not great but the variation of the mark-up is considerable, resulting in a very low r^2. The variation in mark-up is largely caused by the licensing system so that the effect of duties on the prices at the margin is very low.

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[16] There is some factual support for our conclusion. Mr. A.I.A. Islam compared the actual imports during the period 1953-59 with the expected amounts projected on the basis of the OGL XIII period imports in [5]. There he showed that for some of the commodities the actual imports under the licensing system have exceeded projected ones and for some other commodities they fell short of expected amounts. We ranked the commodities in order of "liberality" of licensing and examined the rate structure for these commodities. The ranking conforms to the ranking made on the basis of extent of duty. We show it in the following table:

Group of commodities	Percentage changes in the estimated values of imports from actual values	Average rate of duty
Machinery	+296.3	12.5
Oils	+275.2	44
Chemicals	+130.5	47
Rubber	+ 63.0	38
Vehicles	+ 60.8	53
Food	— 26.7	76
Soap	— 62.3	73
Textiles	— 81.9	150

Source: Col. 2 from [4]; Col. 3 from [13].

In addition, Radhu [18] has shown that the rate of duty varied by "essentiality" of the commodity imported, and found higher rates of import tax on luxury consumer goods, lower on consumer durables and on semi-luxuries and lower still on "essential" consumer goods. Duties on raw materials for consumption goods were higher than on raw materials for capital goods. If the licensing authority followed similar patterns of gauging the "essentiality" of imports the regression results are explainable without having duties exercise their influence on private market decisions.

V: A DIGRESSION ON METHODS AND OBJECTIVES[17]

At least two separate aspects of the problem of import licensing should be distinguished when analysing the system, or when making use of the empirical results of surveys such as ours. One aspect is the effect of licensing on the efficiency of resource allocation; the second aspect is the effect on the distribution of income. A few observations are in order on each.

There are basically two possible ways to control prices of imports and quantities sold. The licensing system specifies the quantity which, given the demand conditions, determines the price. This is the way the system in Pakistan presently works. The alternative methods, such as an import surcharge, an auctioning system for foreign exchange, and devaluation, all with differential tariff systems attempt to set the prices and allow the quantity imported of each commodity to be the quantity demanded at that price. Given adequate knowledge of demand and supply conditions, both methods can achieve the same composition of imports and of domestic relative prices.

Consider a hypothetical case in which the industrial licence-holder was not legally committed to use his imports, but might sell them. If a differential surcharge (or a general surcharge with differential rates of import duty) were imposed as a means to mop up all licence-created profit, relative prices would not be affected, and resource allocation would also remain unchanged. With the existing tariff structure, auctioning quotas of foreign exchange for particular commodities could also lead to the same result. To the extent that market equilibrium prices do not equal social opportunity costs, there will be some misallocation of resources in all three cases. If the surcharge is a general one imposed on top of the existing tariff structure, the relative prices and the relative quantities imported would be different from the previous alternative insofar as there are differentials in the profit margins in different commodities under the current licensing and tariff system. A general auctioning system (or fluctuating exchange rate) with the existing tariff structure will also lead to a different set of relative prices. There is no guarantee, however, that these new sets of relative prices will be efficiency prices from the social point of view. Of course, value judgments will play an important role in evaluating all these cases, but the investigation of "efficient" resource allocation in general is beyond the scope of this paper.

Under an alternative system where sale of imports under industrial licences was illegal, if industrial licences were abolished, allocation of resources among different industrial users may be different even if the quantities imported of every commodity remained the same. "The decisions of buyers based upon their

[17] Discussions with Dr. Ronald Soligo and Mr. Abdul Ghafur of the Institute were helpful in developing the argument in this section.

willingness or unwillingness to pay the surcharge would be substituted for the decisions of government officials in determining the allocation of scarce foreign exchange among competing claimants" [3, p. 7]. Those "efficient" industrialists who previously could not obtain licences would now get the materials and would increase productivity per unit of imported goods. Again, insofar as the present licensing is based on incorrect calculations (from the social point of view) of optimal factor combinations, the alternative system would lead to more efficient allocation. The benefits to cottage industries, small and medium-scale industries, which do not get industrial licences under the present system, are also apparent. Whether these industries willing to pay the highest price will invariably be those who would put goods to their most productive uses from the long-run social point of view depends on how closely private and social marginal valuations overlap. It is sometimes argued that "since these (small-scale industries) are generally labour intensive, the small amount of capital equipment which they need would be very highly productive" [3, p. 7]. It is possible, of course, that the large-scale entrepreneur would also prefer to adopt a labour-intensive technology. There is empirical evidence, however, that large-scale enterprises in Pakistan use relatively capital-intensive techniques. But this "inefficiency 'in the large' is caused by the overvaluation of labour relative to its shadow price for the industrial sector as a whole" [19. p. 39]. It cannot be asserted with certainty that the licence-holders resort to "needlessly capital-intensive" technologies due to the low price of capital goods, however.

In any case, if we accept the overall distribution of imports among commodities as it presently exists, the licensing system *in itself* misallocates resources only to the extent that industrial users obtain imports at two different sets of prices, depending on whether they are or are not import licensees. As pointed out above, there is no difference among alternative systems from the point of view of allocating scarce resources, unless one says that the licensing authorities are less efficient in their distribution of imports than are the tariff authorities in their implicit set of differentials between c & f and domestic market prices of imports.

One should be careful to separate the effects on the distribution of income from the effects on the allocation of resources. The alternative to having excess, or above normal, profits accruing to the private sector's import licensees is to have the government appropriate them through an import surcharge, or regulatory duty, or to transfer them to exporters by general or selective devaluation, or a combination of both methods. The superiority of the alternative methods on grounds of income distribution depends on judgments of intersectoral equity and/or the relative efficiency of private and public sector allocations of resources.

If one accepts the distribution of imports by commodities then one can criticise the licensing system from an efficiency point of view only in its dual prices for raw materials, spare parts, and capital goods to industrial users; and from the income distribution point of view primarily from an equity argument, *i.e.*, that the public sector should absorb "excess" profits. One can also criticise the tariff system for not adjusting to absorb the entire difference between c & f and domestic prices at the licence-determined distribution of imports. Alternatively, if one accepted the set of relative differential implied by the tariff system, one can criticise the licensing system for not adjusting its quantitative controls to equilibrate the profit margin for every commodity. But, one should be careful to distinguish his grounds for criticising the system or for making use of the differentials and profit margins investigated in the empirical section of this paper.

VI: SUMMARY AND CONCLUSION

We have found that the average profit margin over landed cost for imported commodities in Pakistan was about 60 per cent during the middle of 1964. This margin is high enough to absorb small changes in the prices to import licensees. The main determinant of the domestic prices of imports at the margin, therefore, is the licensing system, since it restricts supply and gives high profit to the importers.

There has been heretofore no systematic study in Pakistan regarding the profit margins for imports. The Chief Controller of Imports and Exports has, at times, kept track of the prices of the important commodities in order to rationalise his decisions. However, a knowledge of the extent of mark-up over landed cost for most items should be extremely useful to both the Chief Controller and the Central Board of Revenue. This type of study should be helpful in estimating the demand for imports at different import prices and different levels of imports (of course, a knowledge of the elasticities of demand is necessary). A movement towards more liberalisation or towards an "equilibrium rate of exchange" also depends on knowledge of this margin. In order to determine the impact of different policies, the behaviour, under different policies, of such key variables as the value of the rupee and the prices of imports should be analysed. If a continuing study along the lines of the present paper could be instituted by the office of the Chief Controller of Imports and Exports or by the Central Statistical Office and kept on a regular basis, licensing and tariff decisions could be placed on a much more solid empirical footing.

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Appendix A

Selection of Commodities

From a study of the recent literature on import control policy it is evident that consumption goods, raw materials, and capital goods are treated with different degrees of stringency in licensing. Power noted that "foreign exchange is valued more highly in substituting for imports of final consumption goods than in producing equipment" [17, p. 207]. It has also been argued that the major effects of the increase in imports due to recent liberalisation has been in the area of capital goods while raw materials were held under strict control which might result in a low level of utilization of productive capacity. The inconsistency arising out of the degree of stringency in licensing capital goods, consumption goods, and raw materials required that our study investigate how "the pattern of distortions" differed among types of goods. For these broad groups we followed the Planning Commission—ECAFE definitions. Since by these definitions consumer durables are classified under capital goods, we made a further breakdown of capital goods into consumer durables and machinery and equipment and treated the consumer durables and consumption goods together.

Our objective is to find the gap between domestic market price and landed costs for different imported commodities. As the number of commodities imported is large, we chose a few commodities. In order that our conclusions regarding these few commodities may be applied to the whole of the import sector we first selected "representative" commodity groups in the sense that the shares of these commodity groups in total imports were large and then we selected "representative" commodities from those commodity groups on the criterion of the share of these goods in total imports under the particular commodity group. Detailed statistics of imports of commodities were available only up to 1960-61, selection was based on the share of the particular commodities in 1960-61 and assumed that the same commodities would also be important in 1963-64.

Collection of Data

We compared the landed cost of an imported commodity with its domestic price. The main components of the landed cost are the f.o.b. price in the foreign ports, freight charges, import duty, and sales tax. The minor ones, namely, insurance charge, clearance charge, import licence fee, banking charge and wharfage cost amounts to 2 to 2.5 per cent of the c & f costs. So we made allowance for these minor costs as a percentage of the c & f costs and added it to import duty and sales tax to get the total landed cost.

The rates of import duty and sales tax were obtained from the *Pakistan Customs Tariff* [14] and *The Law of Sales Tax* [2] respectively. We contacted different shipping agencies for the freight charges. We are thankful to them for providing us with requisite rate structure of freight charges from the main ports of the countries exporting to Karachi.

In comparing the internal prices of the imported goods with the foreign prices, we had to be careful in choosing comparable foreign and local prices. In the cases of raw materials and capital goods, we compared the immediate delivery wholesale price in the domestic market with the wholesale export prices in the international markets *plus* freight and minor charges *plus* import duty and sales tax. In most of these cases import trade and domestic wholesaling are done by the same firm. We collected the domestic prices from these firms and so the profit margin over landed costs includes in it, among other factors, the "normal" mark-up for the wholesaler. For the consumption goods, it was easier to collect the retail prices in the local market. The international Exporting Houses offer a percentage rebate for wholesale purchases. Assuming that this percentage is the "normal" mark-up for the domestic retailers also, we subtracted it from the domestic retail price to estimate the wholesale price. We are aware of the flaws that can creep in due to this assumption; yet in the absence of any good measure of the "normal" mark-up going to the retailer we retained it.

The Pakistan Institute of Development Economics conducted a survey to collect the prices in Karachi. An enumerator was appointed for this special purpose. For capital goods and raw materials we investigated two sources: the seller and the user. The enumerator asked manufacturers what they paid for their machinery, equipment and raw materials. The Karachi Polytechnic Institute uses some of the commodities for its workshop and laboratory. The store keeper there was most helpful in providing us with the data relating the prices he paid for the different commodities. A contractor who dealt in building and construction materials also extended his help. Wholesale markets in Karachi were visited several times to obtain selling price of the items. We checked both the buying price and the selling price to help reduce any bias on the part of one respondent or the other who might be trying to protect his interest. The prices were very close in all the cases.

Trade Commissions and trade journals were the most helpful sources of foreign prices. For consumption goods the catalogues of the reputed Exporting Houses in free ports have been used.

Product differentiation in cases of consumers' goods and difference in sizes and qualities in cases of raw materials and capital goods necessitated giving

the specifications in a clearcut fashion. We tried to choose some popular brands of a particular consumption good. Then we averaged the profit margins in these brands. For raw materials and capital goods the mark-up for different sizes and qualities have been averaged.

Thus each observation used in the analysis is an average of several items, and all averages given are really averages of averages. The prices represent spot quotation for the items in question so that, at the specified price, delivery could have taken place immediately in the Karachi area in the period June-August 1964.

Appendix B

Licence-Created Profit vis-a-vis the Existence of Domestic Industry

The nature of the licence-created profit remains the same, in essence, even if there is domestic supply of an imported commodity. Of course, domestic supply brings price below the "pure scarcity price" of imports and reduced licence-created profits. If the domestic supply curve is S_DS_D (*see* Fig B-1) and the supply curve for imports is S_MS_M the total supply curve is S_MLRS, when

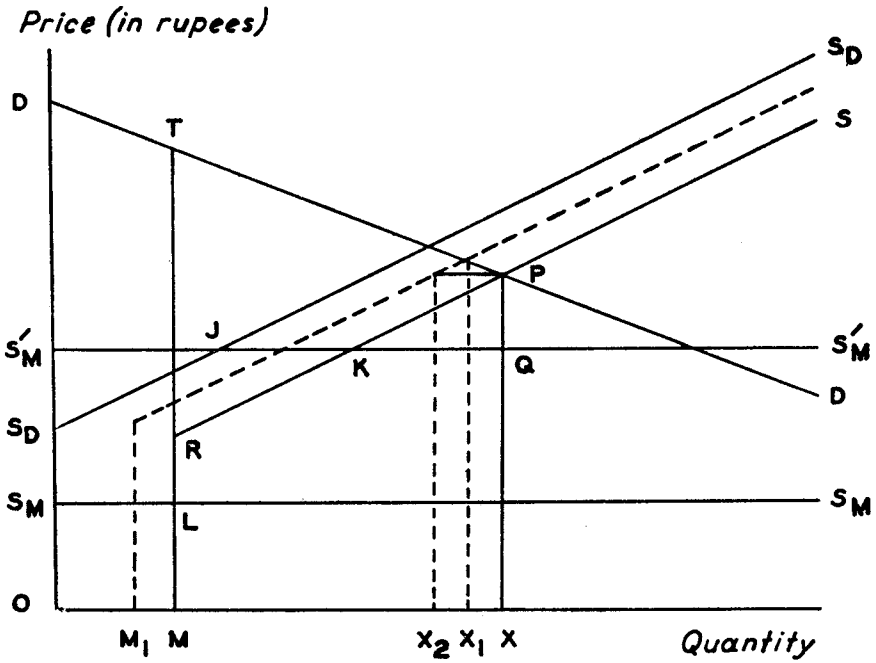

FIGURE : B-1

licensed import is the amount OM. The equilibrium price is PX with OX quantity sold, out of which OM is imported and MX is supplied domestically. MX amount of domestic supply brings down price from TM to PX and licence-created profit for the importer is thereby reduced.

Now, if a rise in landed cost raises the supply schedule for imports to the level $S'_MS'_M$ the new total supply curve will be S_DJKS. Even in the new situation PX will be the price and OX, the quantity sold. $JK = S_DR = OM$ is the (licensed) imported supply and $S'_MJ + KQ = S'_MQ - JK = OX - OM = MX$ is

domestic supply. So, with the presence of licence-created profit, if the licensed import quantity remains at the same level, tariffs have no contribution to protection over a wide range. Raising S_MS_M does not change the equilibrium price until landed cost rises above XP. Increased tariffs will not increase protection within this range, the limits of which are set by the licence-created profit.

But, in this situation, further restriction of imports gives increased protection. If imports are restricted to OM_1 the total quantity supplied becomes OX_1. Imports are reduced by $MM_1 = XX_2$, but the total supply diminishes by XX_1 only. The distance X_2X_1 measures the increase in domestic supply resulting from the increased protection provided by reduced amount of imports. Of course, we have not taken account of the excess production costs and have ignored consumption costs altogether.

TABLE I

RATES OF MARK-UP ON IMPORTED CONSUMPTION GOODS AND CONSUMER DURABLES

Name of the commodity	Import duty (% on c&f value)	Sales tax (% on c&f + import duty)	Total duty (% on c&f value)	Market price—Landed cost / Landed cost	Market price—c & f value / c & f value
(1)	(2)	(3)	(4)	(% terms) (5)	(% terms) (6)
A: Regular Items					
Coffee	80	15	107	30	169
Pepper	5[c]	15	20.75	106	149
Cloves	25	15	43.75	96	134
Saffron	5	15	43.75	67	140
Beer	16[a]	20	39.20	61	123
Citronella oil	30[d]	15	49.50	53	129
Leather polish	60	4	87.20	42	156
Glass tumblers	100	15	130	38	225
Cups and saucers of chinaware	100	20	140	31	220
Safety razor	50	15	72.50	90	227
Electric lamps	40	15	61	36	120
Radios	80	20	116	78	286
B : Bonus Items[b]					
Meat and meat preparation	20[e]	15	38	82	—
Sugar	71[a]	0	71	6	—
Tobacco for pipes and cigarettes	234[a]	0	234	16	—
Domestic refrigerators	30	20	56	5	—
Air conditioners	80	20	116	5	—
Motor scooters	40	15	61	5	—
Bicycles	40	15	61	6	—
Cameras	60	20	92	7	—

Source : Column 2 from [14] ; Column 3 from [2].

Notes: *a*) Rates in these cases were in absolute terms. They have been transferred to a valorem rates by taking the average c & f value as the base.

b) Calculations are made assuming that price of bonus voucher of Rs. 100 worth of foreign exchange = 150 Rs.

c) For British colony.

d) For Ceylon

e) For GATT areas.

TABLE II

RATES OF MARK-UP ON IMPORTED RAW MATERIALS

Name of the commodity	Import duty (% on c&f value)	Sales tax (% on c&f + import duty)	Total duty (% on c&f value)	Market price — Landed cost / Landed cost	Market price — c & f value / c & f value
(1)	(2)	(3)	(4)	(% terms) (5)	(% terms) (6)
A : Regular Items					
Teak sawlog	25	0	25	43	81
Bidi leaf	80	15	107	260	669
Ultramarine blue	35	15	55.25	29	105
Tallow	0	15	15	83	115
Soyabean oil	25	15	43.75	62	138
Cottonseed oil	25	15	43.75	26	83
Coconut oil	15[a]	15	32.25	90	158
Lithophone	35	15	55.25	28	99
Celluloid	25	15	43.75	53	125
China clay	25	15	43.75	54	116
Paraffin wax	30	15	49.50	32	124
Firebrick	30	15	49.50	13	101
B: OGL Items					
Ammonium sulphate	0	0	0	60	62
Agglomerated cork material	25	15	43.75	56	126
Cinematographic films	60	20	92	32	156
Caustic soda	25	15	43.75	26	172
Soda ash	20	15	38	93	173
Calcium carbide	25	15	43.75	22	79
Sodium bicarbonate	25	15	43.75	49	115
Acetic acid	25	15	43.75	72	148
Tyres and tubes	40	15	61	56	154
Copper ingot	5	5	10.25	78	100
Lead ingot	5	5	10.25	108	134
Alluminium ingot	12.50	5	18.12	51	83
Zinc ingot	5	5	10.25	88	89
Tin ingot	5	5	10.25	17	31
C: Bonus Items					
Copra	10	15	26.50	12	
Wool tops	10	15	26.50	75	
Sodium hydrosulphite	25	15	43.75	5	
D: Other Items					
Gum Arabic (automatic)	15	15	32.25	8	50
Pig iron (free)	5	5	10.25	15	27

[a] For Ceylon and British Colony.

Source: Column 2 from [14]; Column 3 from [2].