

The effect of duty drawback on export promotion: The case of Korea

Jai S. Mah*

Division of International Studies, Ewha Womans University, Seodaemun-ku, Seoul 120-750, South Korea

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Abstract

This paper examines whether or not the duty drawback system has contributed to promoting Korea's exports. The unit root tests show that they can be assumed to be integrated of order one. Banerjee et al.'s [Banerjee, A., Dolado, J. J., & Mestre, R. (May 1998). Error-correction mechanism tests for cointegration in a single-equation framework. *Journal of Time Series Analysis*, 19(3), 267–283] small sample error correction mechanism (ECM) test shows that there is no evidence of cointegration. The estimation results show that there are strong evidences of the positive effect of export subsidy in terms of duty drawback on export supply. That is, the efficiently managed duty drawback system may contribute to export promotion significantly.

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1. Introduction

Some countries like the Dynamic Asian Economies have actively tried to promote exports using various means, assuming that export growth would lead to economic growth. Although most export promotion measures are regarded as prohibited subsidies under the current World Trade Organization (WTO) system, one of the non-prohibited export promotion measures is duty drawback, which is a redemption of duty paid on imported inputs used in exports. Tariffs on imported inputs can be regarded as taxes on exported products in the sense that tariffs on imported inputs raise the cost of export production, thereby damaging the competitiveness of the

* Tel.: +82 2 3277 4683.

E-mail addresses: jsmah59@yahoo.com, mahsong@hotmail.com.

export sector. Lots of countries have tried to eliminate this source of the tax on exports by instituting duty drawback schemes, which aim at providing exporters with access to imported inputs at international prices (WTO, 2003).

The duty drawback systems are often justified in the sense that they tend to correct the anti-trade bias imposed by high tariff levels (Cadot, de Melo, & Ollareaga, 2003). Unlike developed countries whose import tariff rates are quite low, there is much room for application of duty drawback to promote export in developing countries where average input tariff rates are high (Thomas, Nash and Associates, 1990). Although the duty drawback system as an export promotion measure is not prohibited up to a certain threshold level under the current WTO system, only a few rigorous attempts such as Chao, Chou, and Yu (2001) have so far been made to reveal empirically whether or not it has actually been effective in the promotion of export.

This paper examines the effectiveness of the duty drawback system in the promotion of export in Korea whose development strategy has often been characterized as export-led growth, assuming infinitely elastic export demand, and finds that it has contributed significantly to promoting exports. The structure of the paper is as follows: Section 2 explains the characteristics of the duty drawback system under the WTO and its evolution in Korea. Section 3 introduces the model which examines the effectiveness of duty drawback in export supply. Empirical evidences are shown in Section 4. Section 5 provides conclusions.

2. The duty drawback scheme

The Korean economy has pursued the export-led growth strategy during the period of rapid economic growth. In the meantime, the Korean government has used various measures to promote exports: taxational benefits, policy loans at preferential rates, export credit, and duty drawback, among others. Although the importance of taxational benefits and policy loans at preferential rates has diminished since the mid-1980s and they have been prohibited by the Agreement on Subsidies and Countervailing Measures of the WTO, the WTO Subsidies Code hereafter, duty drawback has been acknowledged as the non-prohibited subsidy in the WTO. Duty drawback not exceeding the amount of duty actually levied on the imported product has been explicitly permitted by the GATT Article VI:4, although the over-rebate of duties was characterized by the 1960 GATT Working Party as a subsidy liable to countervailing duties (Hufbauer & Erb, 1984). The current WTO Subsidies Code provides the illustrative list of the prohibited export subsidies. There are a few measures that can be used to promote export, although they are not stipulated as the prohibited export subsidies, which include the duty drawback system.

Like many other developing economies, the Korean government has actively used the duty drawback system to promote its export since it was instituted in July 1975. Together with the export insurance system, it has been the main export promotion measure, in particular for the past two decades or longer (Mah & Song, 2001). The imported raw materials to be used to produce export products have been subject to duty drawback by the Special Act for Duty Drawback in Korea.

The amount of duty drawback was as low as 0.1 trillion won in 1975, while it increased gradually to between 1 and 2 trillion won on average per year during 1984–1997. To overcome the balance of payments difficulties during the period of the economic crisis, the Korean government has increased the amount of duty drawback significantly since 1998. In 2001, the amount of duty drawback reached 2.3 trillion won, sharing 38.4% of total tariff revenue. During the late 1970s–the 1980s, the amount of duty drawback/export values was between 4 and 8%,

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