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ACRONYMS AND ABBREVIATIONS

AD	Anti-Dumping
AMS	Aggregate Measure of Support
AoA	Agreement on Agriculture
ATC	Agreement on Textile and Clothing
BIS	Bureau of Indian Standards
CVD	countervailing duties
DEPB	Duty Exemption Passbook
DGFT	Directorate General of Foreign Trade
FDI	Foreign Direct Investment
FTA	Free Trade Agreement
GATT	General Agreement on Tariff and Trade
GDP	Gross Domestic Product
GOP	Government of Pakistan
GSP	Generalized System of Preferences
IT	Information Technology
MFA	Multifibre Arrangement
MFN	Most Favoured Nation
NAFTA	North American Free Trade Area
NTB	Non-Tariff Barriers
NTC	National textile Corporation
PSU	Public Sector Units
QR	Quantitative Restrictions
REER	Real Effective Exchange Rate
RMG	Ready Made Garments
ROW	Rest of the World
RTA	Regional Trade Agreement
SAARC	South Asian Association for Regional
SAD	Special Additional Duty
SAFTA	South Asian Free Trade Area
SAIL	Steel Authority of India
SPS	Sanitary and Phyto-Sanitary
STE	State Trading Enterprises
T & C	Textile and Clothing
TBT	Technical Barriers to Trade
TPR	Trade Policy Review
TRIMs	Trade Related Investment Measures
TRQ	Tariff Rate Quotas
VAT	Value Added Tax
WTO	World Trade Organization

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Operational Summary

Introduction

During the last decade, South Asia's five largest countries – India, Pakistan, Sri Lanka, Bangladesh and Nepal – have been implementing trade policy reforms, gradually moving their economies away from protectionism toward greater trade openness and global economic integration. In the late 1980s and early 1990s, the four mainland countries began to follow the liberalizing course on which Sri Lanka had embarked in the late 1970s. For five years after 1997, trade liberalization in India moved ahead in a major way with the removal of most remaining QRs, but it stalled and went backwards in some other respects. However, the liberalizing momentum resumed with large cuts in industrial tariffs between 2002 and February 2004. In Bangladesh, from the mid-1990s some aspects of trade policy reform continued, although more slowly, but in other respects import policies steadily became more selective and protective until this trend was reversed to some extent in Bangladesh's 2004/05 budget.

Other developments -- Pakistan's comprehensive liberalization of its trade policies since 1996/97 (including its agricultural trade policies), and Sri Lanka's potential to resume long-deferred reform as prospects improve of ending its civil war – contribute to a regional picture of very mixed achievement but widely shared opportunity. The South Asian countries missed the tide that carried many of their East and Southeast Asian neighbors to record rates of growth and poverty reduction during the 1960s and 1970s, but their later trade policy and other liberalizing reforms came in time to for them to benefit from the expansion of production and trade in the world economy during the 1990s. They now have an opportunity to undertake a third phase of reform in which they could further lower their barriers against trade-by general developing standards still very high in Indian and Bangladesh- and further strengthen their economies' performance through international commerce and competition.

Each country faces differing opportunities to exploit and resistances to overcome. Because many of their circumstances and choices are similar, however, this paper seeks to assess their situations collectively as well as separately. Many of its findings are broadly applicable. So, with allowances for historic, economic and social differences, are many of its policy recommendations.

The bulk of the report describes key aspects of the current trade regimes in the five largest South Asian states and the policies and practices that have produced the systems now in place. It principally focuses on traditional trade policies which affect imports and exports i.e. tariffs, non-tariff barriers, anti-dumping, export policies, and to a limited extent aspects of sanitary and technical regulations which affect trade. All of these are still major issues of concern and debate in South Asia. *The report does not attempt to describe where the South Asian countries stand on newer trade policy issues which are prominent in WTO negotiations, such as trade in services, intellectual property, government procurement and Customs valuation*. To do so comprehensively for each of the five major countries would be a major new task on its own. The report also does not attempt to place the South Asian countries' trade policies in the context of their trade and other aspects of their economic performance. Its purpose is rather to provide up-to-date information about, and interpretations of, the current trade policies it covers, with the idea that this should provide starting points for further applied economic research on useful and relevant topics, as well as points of reference and factual information for discussion and debate.

Nevertheless, the report does assess, on theoretical and empirical grounds, the appropriateness of the policies described. Conclusions and suggestions for change are generally summarized at the end of each stocktaking section. This ***summary***, in condensing the work of stock-taking, highlights the key issues that all or most of the countries have addressed and need to pursue further. To reinforce the operational nature of those findings, the summary deals with the recommendations next, as an immediate continuation of the central policy questions. It then reviews trade policies in three key sectors-agriculture, fertilizers, and textiles and clothing.

Key Trade Policy Issues in South Asia

Trade, growth and poverty reduction

The broadest finding is not unique to the South Asia region or this examination of trade policies. It stems from the experience of nations everywhere since the end of World War II: openness to external trade and foreign investment permits more rapid economic growth than protectionist regimes achieve; in developing countries that choose integration with the global economy, such growth proves an efficient, effective instrument of poverty alleviation. In South Asia, during the 1990s, as India and Bangladesh followed Sri Lanka into the ranks of countries known as rapid globalizers, strong growth tallied with sharp drops in poverty incidence – from 51% in 1977-78 to 27% in 1999-2000 in India, and from 45% in 1991 to 34% in 2000 in Bangladesh.

Supported by both general and regional evidence, the premise of this study is that the poor of South Asia would be among the significant beneficiaries of wider, faster, more determined trade liberalization than policymakers have so far pursued. A major finding of recent empirical research on international economic integration (Art Kraay and David Dollar, 2001) has been that a third of the developing countries of the world, described as "rapid globalizers", did extremely well in terms of income growth and poverty reduction over the past two decades or so. These countries, which include Bangladesh, India and Sri Lanka in South Asia, have also experienced large increases in trade and significant reductions in tariff and non-tariff barriers. For the South Asia region as a whole, the period 1985-2000 saw significantly higher per capita GDP growth performance, although Pakistan (political reasons) and Sri Lanka (ethnic conflict) suffered setbacks in the 1990s (Fig.1 &2). The effect on reduction in poverty in India was dramatic, entirely in keeping with the Bhagwati hypothesis of the early 1960s that growth is the principal driver of poverty reduction.

Fig. 1 South Asia's Poor (Headcount ratio 2000)

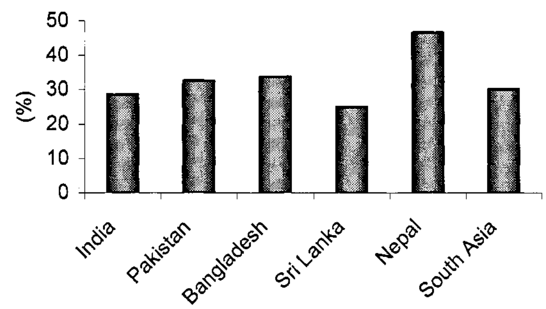
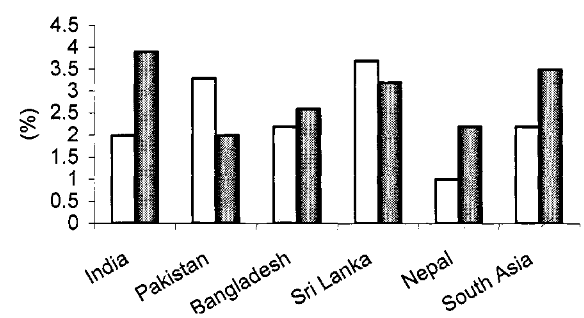


Fig. 2 South Asia's Growth Performance 1975-85 and 1985-2000 Per Capita Growth



For the South Asian developing countries, well endowed with labor, trade openness is expected to stimulate production and expansion of labor-intensive exports, thus generating employment, raising wages, and thereby reducing poverty. But the linkage between greater trade openness and poverty reduction need not be direct, but rather through the positive impact of trade expansion on growth performance – a correlation that has been established in extensive empirical research. Cross-country studies on the relationship between growth performance and poverty reduction lead to the conclusion that there exists a close correspondence between growth of per capita income and growth of incomes of the poor, though not all growth is necessarily pro-poor.

More importantly, trade openness is a necessary, not a sufficient condition for rapid growth. Trade policy reforms generally need to be accompanied by complementary measures for ensuring macroeconomic stability and efficient financial intermediation, improving infrastructure services, removing burdensome regulations and in these and other ways, improving the investment climate for private enterprise.

The political economy of protection

There is now a broad consensus in South Asia that openness to trade must be a key component of policies to accelerate economic growth. Despite this, when it comes to actually implementing measures that reduce protection or subsidies for domestic producers, as elsewhere in the world, there is understandable opposition from the enterprises and other interest groups that feel that they may be adversely affected. The interests which resist change often include the bureaucracies which are responsible for the administration of tariffs and protective controls, which frequently see trade liberalization as a threat to their jobs and the incomes which go with them, both their salaries and the informal opportunities that their positions provide for extra-legal incomes. This opposition is often reinforced by long held attitudes carried over from the post-independence pursuit of inward-looking, government-directed economic policies that have a basic distrust of both private enterprise and international markets, and consider that the best path to economic development is the promotion of domestic output, owned or at least controlled by the public sector, as a substitute for imports.

In spite of strong international evidence to the contrary, there are still many groups in South Asia with political connections which hold these and similar views, especially in India, Bangladesh and Pakistan. Their influence on trade policy has been minor in recent years in Pakistan, but it is significant, although declining rapidly in India and Bangladesh. There are also strong protectionist forces at work in some sectors in Sri Lanka and Nepal, but these are predominantly driven by straightforward producer interests (notably agricultural protectionism in Sri Lanka) and have little to do with general ideological positions opposing open trade. However, an important new development throughout the region that is creating pressures for increased protection of agriculture (understood in the broad sense to include livestock, fisheries and food processing industries), is much greater awareness than in the past of the instability of international commodity prices and the difficulty of managing these price swings if domestic agricultural markets are open to imports and very large numbers of small scale, low income farmers would be affected. These positions have been reinforced by the continuing strong resistance in developed countries to the scaling down of their agricultural subsidies in the ongoing WTO negotiations. These two factors underly strongly protectionist and interventionist trends in Indian agricultural trade policies over the past few years, similar but less marked trends in Bangladesh, and the continuation of high protection for Sri Lanka's major import substitution crops.

With such attitudes still strong, trade policy reforms in the South Asia region frequently face stiff resistance, and there are active and often successful efforts not only by established interest groups but also by new firms and industries, to obtain special treatment or to be excluded or partially excluded from general trade liberalization measures. The ability of individual producers and producer groups to negotiate for and obtain special treatment is greatly facilitated when trade regimes are complex, *ad hoc* and non-transparent. Overall, the South Asian countries have made considerable progress in simplifying their trade regimes and making them more transparent, especially through the elimination of most QRs, the reduction and simplification of Customs schedules, and greatly improved up-to-date and publicly available information. However, there are some important exceptions to these trends, notably in Bangladesh where easily understandable basic information on the trade regime is unavailable or difficult to obtain, and where the tariff system remains complex and obscure, mainly due to the proliferating use of para-tariffs. In India, new forms of *ad hoc* and non-transparent protection have emerged, especially through the widespread use of anti-dumping, specific duties, and SPS and TBT rules.

In this regard, the report emphasizes the importance of cross-border spillover effects in the region, not only on trade but on trade policies. This is especially pertinent for India's policies, which are carefully watched in the smaller contiguous states, in some cases encouraging policy makers to undertake similar liberalizing reforms, with broad support from their own constituents, but in others making it more difficult to resist new protectionist measures.

As is the case throughout the world, in both developed and developing countries, in South Asia inertia, ideological opposition, the existence of groups that gain from restricting trade, and others that feel that they would lose from the resulting competition, have slowed the momentum towards more open trade policies. The region's trade reform agenda, as a result, remains vast and unfinished. In the next section, we outline some broad policy areas where progress is needed, to degrees which vary considerably by country and by topic.

Priorities and recommendations for trade policy reform

Trade policies and exchange rate policies

One broad area of notable advance which has facilitated trade policy reforms, in the region, is the move towards more market-based exchange-rate regimes. India, Pakistan, and Sri Lanka now maintain floating exchange rates; Bangladesh, which had a moderately flexible exchange rate system after 1991, floated its currency as of May 2003. Maldives's currency is pegged to the US dollar, and periodically devalued. Nepal's and Bhutan's currencies are pegged to the Indian rupee. Floating or flexibly managed exchange rates have been important supports for the trade liberalizations that have occurred in the region, by offsetting or partially offsetting the effects of QR removal and tariff cuts on import competition for domestic industries, and by increasing the domestic currency prices received by export industries. Because of their fixed exchange rates with the Indian Rupee, for Nepal and Bhutan, these effects have been partial and indirect and have not affected their trade with India. More generally, unlike the other South Asian countries, they are not able to use the exchange rate as a means of adjusting to terms-of-trade and more general macro-economic changes.

The massive devaluation of the Indian Rupee between 1985 and 1992 (in real terms almost 150% as measured by its Real Effective Exchange Rate index or REER) facilitated India's initial slow trade liberalization during the late 1980s, and made its much more sweeping post 1991 import liberalization program on the whole quite painless. Because Nepal's currency is tied to the Indian Rupee, the same Indian devaluation also supported the major liberalization of Nepal's import policies that was implemented in the early 1990s. Pakistan's REER was devalued at a steady rate between the mid-1980s and 1992, stabilized at or slightly below this level until mid 1998, and then was devalued rather sharply until late 2001, after which it strengthened somewhat. The continuing real devaluation trend was in part a consequence of, but has also facilitated, trade liberalization, especially the new program that commenced in 1997.

Bangladesh's REER has been remarkably stable for over 20 years. The strength of the Taka is in part due to the rapid growth of ready-made garment exports and increasing remittances from Bangladesh workers outside the country. Together, these more than offset aid inflows which declined relative to GDP, and were sufficient to balance whatever increases in imports resulted from the trade liberalization measures that were implemented during the late 1980s and early 1990s. Compared to India and Pakistan, the Sri Lankan REER has moved within a relatively restricted range and currently the index is only about 10-15 percent below its level 22 years ago. An important reason for the relative stability of the Sri Lankan Rupee has been the rapid and sustained expansion of garment exports and tourism receipts. In Sri Lanka as in the other South Asian countries, in recent years flexibly managed or floating exchange rates have replaced the periodic official use of multiple exchange rates in the past, and largely eliminated black market premia, both of which used to be a source of distortions and rent seeking behavior that complicated the administration of import and export policies.

The Indian devaluation up to 1992 was more than sufficient to sustain the pre-announced tariff reduction program that continued into the 1990s, and from 1992 to the present India's REER index has remained at about the same level, reflecting nominal exchange rate changes that have approximately offset but not exceeded India's inflation rate relative to the inflation rates of its principal trading partner countries. However the initial devaluations were much larger than the devaluations that occurred in Pakistan, Bangladesh and Sri Lanka, with the result that the Indian Rupee became much cheaper relative to their currencies in real terms. This has helped spur Indian regional exports, both recorded exports and unrecorded informal exports, especially to Bangladesh and Sri Lanka, while making it more difficult for these countries to export to India. This expansion of Indian exports to the region represents a correction of many earlier years during which exports which would otherwise have occurred were constrained by import barriers in the other South Asian countries, and by the substantial overvaluation of the Indian Rupee, which was in turn a consequence of its own highly restrictive import policies.

The resulting bilateral trade deficits and increased competition for domestic industries have affected regional trade policies, with resistance to the expansion of tariff preferences for India in Bangladesh, and by contrast a Sri Lankan initiative which culminated in 2000 in a free trade agreement with India. In Sri Lanka, the free trade agreement was perceived as having relatively low trade diversion costs on the import side owing to Sri Lanka's generally low tariffs, and substantial potential benefits on the export side, provided India was willing to offer tariff exemptions for products which Sri Lankan exporters can supply and which are still subject to high MFN tariffs in India. In Bangladesh, on the other hand, tariffs and therefore the probable trade diversion costs of preferential Indian imports are high, as would be the competitive impact on local industries, while there is much pessimism about the prospects of Bangladesh exporters succeeding in the Indian market, even with duty free access.

Following the Asian financial crisis of 1997, the exchange rates of a number of the East and South East Asian countries, including South Korea, Indonesia, Thailand, and Malaysia were sharply devalued in real terms in relation to the South Asian currencies. This increased competition for South Asian exports and slowed down their growth, and at the same time sharpened import competition. With the notable exception of Pakistan, this increase in import competition was an important factor in the slowing of the general momentum of import liberalization in the South Asia region, and its reversal in some respects in India and Bangladesh between 1997 and 2002. The resumption of trade liberalization in India and Sri Lanka during 2002, in part reflected improvements in their balance of payments situations, which in turn are linked to a pick-up in the growth of manufactured exports, in India the rapid expansion of software exports, and increased capital inflows. Consequently, in contrast to the earlier trade liberalizations, real exchange rates have so far not weakened significantly and in the case of India have strengthened to some extent. As a result, the effects of reforms such as tariff reductions on import competing activities are presently not being cushioned by exchange rate devaluation, which in turn has meant that they are politically more difficult to manage, with pressures to make exceptions for firms or industries which are able to lobby effectively, or to obtain special treatment in various ways e.g. through tariff increases, tariff reductions for intermediate inputs , anti-dumping in India, or through the application of SPS and TBT rules.

Recommendations on exchange rate policies

Exchange-rate liberalization lays a foundation for, and facilitates greater openness in trade, and it is desirable that the present flexible exchange rate policies being followed in India, Pakistan, Bangladesh and Pakistan should continue. However, exchange rate flexibility is compatible with whatever trade policies these four countries choose to follow, including the continuation, tightening or loosening of their tariff and non-tariff barriers to imports and other interventions in trade. For Nepal and Bhutan, there are obvious major advantages in retaining the peg to the Indian Rupee, but this means that adapting to external and internal changes and shocks in an economically efficient manner, to a large extent needs to be handled through production adjustments rather than through alterations to trade policies (e.g. tariff increases). How the principal traditional instruments of trade policy are presently being managed in South Asia is discussed in the following sections.

Non-tariff barriers to imports

Compared to their past role these import barriers have shrunk dramatically throughout the region. Until very recently India still had very comprehensive import licensing applied to all consumer goods, which were defined to include textile fabrics and most agricultural products: for most of these products it was a *de facto* import ban. The last 715 goods on this list were only finally removed in April 2001. Since then, except for a few products in Sri Lanka and Nepal, only Bangladesh still operates traditional QRs with the explicit purpose of protecting local industries, the most important of which are restrictions on the import of a range of textile products. It has also retained general administrative controls over imports which, depending how they are implemented, can amount to a form of import licensing. Pakistan has abolished all its traditional QRs, with the important proviso that all imports from India are banned, except for a positive list of 677 items. This restriction is an outcome of the difficult political relations between India and Pakistan. India does not impose equivalent formal restrictions on exports to or imports from Pakistan, but other restrictions (e.g. on travel, remittances, Customs clearance etc) are generally believed to have a similar effect, especially as regards imports.

Even though formal protective import licensing has been abolished, a number of formally GATT-compatible non-tariff import controls over imports which act as protective NTBs, or have the potential to do so, are being operated in South Asia. These include:

- *Government mandated import monopolies or State Trading Enterprises (STEs).* India is the principal remaining user of STEs to control imports, notably of rice, wheat, all coarse grains except maize and barley, and copra. These crops between them account for about 40% of Indian agricultural GDP. India imports of most petroleum products and of urea are also controlled by STEs. In the other South Asian countries, import monopoly STEs are important in the petroleum sectors, but otherwise their role has been drastically reduced, in particular in agricultural products and fertilizers where they previously played a major role.
- *Tariff rate quotas (TRQs)* are being used by India to protect its powdered milk and maize producers. These were introduced quite recently to permit small quotas of these products to be imported over moderate tariffs, while applying high tariffs (respectively 60 percent and 56 percent) which are probably prohibitive, to imports in excess of the quota amounts. The high tariffs for the out of quota quantities are compatible with India's WTO commitments under the Agreement on Agriculture because of its high bindings (respectively 60 percent and 100 percent for these products).
- *Technical standards and regulations.* New rules introduced in 2000 and being administered by the Bureau of Indian Standards (BIS) are reported to be seriously restricting imports of a number of

other products (including steel products for several years), but less is known about the situation in the other South Asian countries.

- *Sanitary and phytosanitary (SPS) rules*. Considerable attention is presently being paid in South Asia and elsewhere to the effects of developed country SPS rules on South Asian exports, but practically none to the potential import-restricting effects of the South Asian countries' own rules. Some applied research on this aspect of SPS in South Asia would be useful.
- *Other health and safety regulations*. As an example, import bans or restrictions on second hand goods are justified on these grounds, but the predominant motive in many cases is clearly the protection of local producers e.g. the import of used clothing is banned in India but is allowed in the rest of South Asia; the import of second hand cars is banned in Pakistan and restricted in India (in both countries there are heavily protected auto industries) but permitted in the other South Asian countries where there is no auto production; the import of second hand household machinery (e.g. refrigerators, air conditioners) is banned Pakistan and restricted in India, but permitted elsewhere.
- *Local content (Trade Related Investment Measures or TRIMS) schemes which act as import QRs* have been widely used for many years throughout South Asia, but were never challenged even though they are clearly incompatible with basic GATT principles. The situation changed after the GATT rules were consolidated in the WTO TRIMS agreement, and India and Pakistan came under pressure from other WTO members to discontinue these arrangements. As a result, India dropped its local content program for the auto industry, and Pakistan has been phasing out local content rules applied to various engineering industries. However, in June 2004, Pakistan's auto local content program was still being operated, and there are also a number of TRIMS-style regulations in force in Bangladesh.

Recommendations on non-tariff barriers to imports

The use of import licensing, quotas and other quantitative controls over imports in order to protect domestic production, was the dominant and probably the economically most costly feature of the past import substitution trade regimes in South Asia. For many well known reasons, it is not in these countries' interests for protective NTBs to continue in explicit form, or to reemerge in new forms under the cover of GATT-consistent provisions allowing STE import monopolies, or health and safety, technical and similar regulations to be applied to imports. Many of these non-tariff barriers could be abolished forthwith or relaxed and then removed during some pre-agreed period. Failing this, careful economic cost-benefit studies could be initiated, to recommend ways of phasing them out, and to suggest alternative ways of achieving objectives such as consumer protection. These principles should be applied generally to existing NTBs and also to proposals for new ones. Some of the NTBs that have been identified in this overview include:

- Bangladesh's list of banned and restricted products, and the institutional holdovers from its old general import licensing system
- Other QRs e.g. Sri Lanka's bans on imports of tea and spices, Nepal's ban on imports of machine made woolen yarns.
- TRIMs regulations, especially Pakistan's TRIMs applied to its auto industry.
- Pakistan's positive list for imports from India. This should be revisited, and when politically feasible, expanded or abolished, preferably in conjunction with the relaxation of travel, communication and other barriers to business relations by both countries. SAFTA (the South Asia Free Trade Agreement) signed in January 2004 provides an appropriate and obvious opportunity for removing these barriers to bilateral trade.
- Regulations which prevent or restrict imports of second hand goods, especially in India and Pakistan.

- India's parastatal import monopolies of rice, wheat and other agricultural commodities, and its agricultural TRQs. These are linked, however, to a broader set of agricultural/food security policies, and removing or phasing out the import barriers would need to be part of broader reforms of these policies.
- State trading import monopolies of petroleum products, fertilizers, and others.
- The use of sanitary and phytosanitary (SPS) rules and technical regulations to limit imports and protect domestic producers. Under the WTO SPS and TBT agreements, these rules are supposed to not discriminate between imports and domestic products. It would be in the economic interests of South Asian countries to modify rules that are in fact discriminating (e.g. the Indian BIS rules) and to ensure that new rules are framed and actually applied in a neutral manner. Pro-active domestic initiatives to do this would be far preferable to allowing protective SPS and TBT rules to function in the expectation that an exporting country will perhaps eventually object at the WTO.
- Restrictions on the port and inland Customs posts at which specified products can be cleared. This technique has been used by India since 2001 to monitor and restrict imports of 300 "sensitive" products, and independently of that, both India and Bangladesh have established quite restrictive lists of the products which can be cleared at most land border Customs posts. The resulting transport costs to reach authorized Customs posts are a major constraint on legal bilateral trade in the region.

Tariffs

Tariffs and protection levels. Tariffs are now the principal means by which the South Asian countries protect their domestic industries. Sri Lanka embarked on trade liberalization and reduced tariffs substantially in the late 1970s, and currently has the lowest average tariffs in the region. During the 1990s the other four major South Asian countries steadily reduced their tariffs, starting from very high and in many cases prohibitive levels in the case of India, Pakistan and Bangladesh. By about 1997, in India and Bangladesh, these tariff reductions started to bite and reached the point where for an increasing number of domestically produced products much or most of the previous "water" or tariff redundancy had been eliminated. This occurred at the same time as a slump in the world prices of many commodities and manufactured products which accompanied the Asian financial crisis, and, for India, when it was under pressure at the WTO to lift its longstanding QRs on consumer goods, which had been in place for about 40 years, and which for most products were equivalent to an import ban.

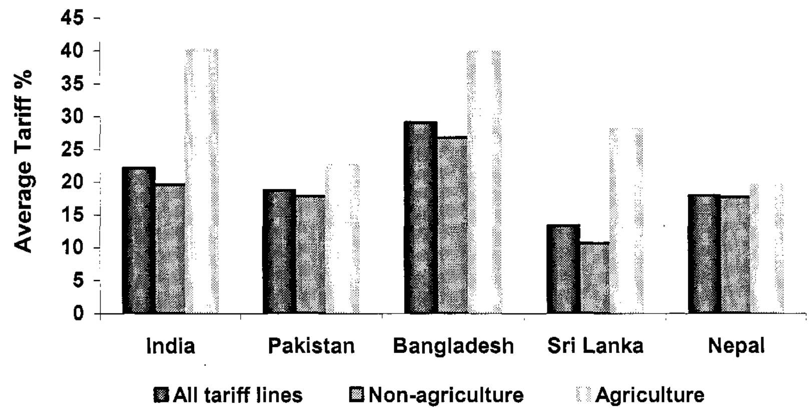
This partly explains a five year period between 1997 and 2001 during which there was backtracking on tariff reform in India, and in Bangladesh a longer period from 1995/96 to 2003/04 during which there practically no further reduction in average total protective tariffs, and big increases in protection rates for selected import substitution industries. During 2002, tariff reform in India resumed, with successive reductions in industrial (but not agricultural) tariffs in its 2002 and 2003 budgets, and a final sharp reduction in February 2004. As of June 2004, the general maximum protective duties (including generally applied para-tariffs as well as Customs duties) which apply to most but not all products (there are products subject to higher customs duties than these generally applied maxima) in the South Asian countries were estimated as follows: India, 30%; Pakistan 27%; Bangladesh 29%; Sri Lanka 31.25% ; Nepal 29.5%[2]

[1] These maxima are those in force in April 2003, and in the case of India are the new rates promulgated its 2003/04 budget which announced a new reduced "maximum" Customs duty of 25%. However, all agricultural tariffs were excluded from the reduction and many of these as well as a large number of non-agricultural tariffs remain at 30%, and others at rates well above this. 30% therefore has been treated as de facto general maximum rate.

[2] For explanations of these estimated maxima, see Chapter 3

Other protective import taxes. Except in India,, Customs duty rates alone give a misleading impression of actual protection rates for domestic industries, since Pakistan, Bangladesh, Sri Lanka and Nepal also employ other protective import taxes (para-tariffs) which are applied on top of Customs duties. India was also a regular user of para-tariffs until the last one was dropped in February 2004. In Pakistan, Sri Lanka and Nepal the para-tariffs are applied across-the-board to all or most tariff lines, but as well as a general para-tariff of this type, Bangladesh also uses three other protective taxes for selected products. In addition to this, India in particular and to a lesser extent Pakistan, Sri Lanka and Nepal use specific tariffs, which can correspond to very high ad valorem equivalent rates, depending on import prices. It is not possible to quantify the overall impact of the specific tariffs, but estimates of the unweighted averages of the combined protective effect of Customs duties and these other taxes are shown in Fig 3. According to this indicator, Bangladesh has by far the highest tariffs in South Asia. After allowing for para-tariffs, Bangladesh's average protective rate declined only slightly after 1995/96, from 32% to 29% in 2003/04, and to 26.5% in 2004/05. On average, protective tariffs in the other South Asian countries are markedly lower than in Bangladesh. They are about the same in Pakistan and Nepal and slightly lower in both countries than in India. With the important exception of agriculture, Sri Lanka is a relatively low-to-medium low-tariff country by the general standards of developing countries.

Fig 3
Unweighted averages of customs duties plus other protective import taxes in 2003 or 2004



Despite the tariff reduction programs carried through in recent years in India and Pakistan, overall, by world standards, the South Asian countries are still among the more highly protected: except for Sri Lanka, they all come within the top 20% among 139 developing countries. By this indicator, Bangladesh is now one of the most highly protected developing countries, in one comparison ranking fifth after Tunisia, Morocco, Bahamas and Mauritius. India's recent tariff reduction program has however removed it from the group of countries with exceptionally high average tariffs. On the other hand India's and Bangladesh's average agricultural tariffs are respectively seventh and tenth highest (after Tunisia, Turkey, Korea and Morocco) among 106 developing countries, and average agricultural tariffs are also exceptionally high in Sri Lanka.

Tariff complexity. As well as reducing the tariff levels, past reforms in South Asia have also reduced the complexity of Customs duties by cutting the number of "tariff slabs" i.e. the number of generally applied Customs duties rates. There are now just four normally applied Customs duty rates in Pakistan, and including zero, five in Bangladesh and Nepal, six in Sri Lanka, and seven in India. But this commendable simplification has been undermined by the retention of Customs duty rates above the normally applied range, and the use of specific duties, other protective import taxes, *ad hoc* exemptions and partial exemptions, and preferential tariffs under SAPTA and other arrangements such as the India-Sri Lanka free trade agreement. The resulting continuing complexity is most marked in India and Bangladesh. In India, specific tariffs now account for just over 5 percent of total tariff lines, there are 17

Customs duty rates in excess of the normal maximum of 30 percent, and large numbers of exemptions and partial exemptions. In Bangladesh the situation is even more complex and also opaque, owing to the use of three other protective taxes on top of Customs duties, and the deliberate use of the VAT system to provide extra protection for selected products by levying VAT when a product is imported, but exempting the same product from VAT when it is produced domestically. During 2003/04 the use of these taxes and devices in Bangladesh increased the unweighted average protection from about 18.8 percent (Customs duties only) to 29.1% percent i.e. they accounted for more than a third of average protection provided by Customs duties and other import taxes. More significantly, these taxes ("supplementary duties", "regulatory duties" and the use of VAT for protection) were being used to selectively provide very high levels of protection against imports to domestic production of a large number of products, in a general range of between 50 and 100 percent, but going as high as 143 percent (salt) and 131% (sweet biscuits). Compared to India and Bangladesh, protective tariffs are much less complex in Pakistan, Sri Lanka and Nepal. In Pakistan imports are subject to an income withholding tax which has some protective effects, but the estimated protective incidence of that for most products is relatively small. There are no other explicitly protective import taxes other than Customs duties, not many specific duties, and only a few ad valorem rates in excess of the general 25% maximum (albeit protecting some large industries) and the number and scope of *ad hoc* exemptions has been declining as Customs duties on intermediate goods and machinery have come down. Sri Lanka and Nepal have some across-the-board but relatively low protective import taxes which are added to Customs duties. The principal complications are a number of specific duties on key commodities in Sri Lanka, and in Nepal a rather large number of products subject to high Customs duties (40, 80 and 130 percent) which are well above the general maximum of 25 percent.

Tariff escalation. As in many other countries, most tariffs in South Asia are systematically escalated according to the degree of processing involved, with raw materials subject to the lowest tariffs, processed materials and components subject to higher tariffs, and final consumer goods subject to the highest rates. Two general consequences of this are to provide higher effective protection to the processing margins of processes further down the chain than to the earlier processes, and to further increase the discrimination of protective tariffs against exports, unless exports are subsidized. The "tops down" approach to tariff reductions that has been typical in South Asia has greatly reduced the extent of escalation by pushing most top Customs duty rates to lower levels, but it still remains a major source of distortions with big differences in effective protection rates both within the import substitution sectors of these countries, and between import substitution activities and export activities. This is a major problem even in the manufacturing sectors of Sri Lanka and Nepal, where average tariffs are low but the extent of escalation benefiting some processes is considerable. Mainly reflecting the greater diversity of its economy, India's tariff structure is much less escalated than the tariff structure of the other South Asian countries, with most Customs duties concentrated near the top of the normal range, but there is still considerable potential for very high effective protection rates, in part resulting from *ad hoc* tariff exemptions for key inputs, and in part from selective above- normal protection rates for finished products through the use of high tariffs, specific duties, anti-dumping and other means. In Bangladesh, the proliferation of para-tariffs on top of Customs duties has enabled a large number of import substitution industries to escape from the reduced protection and the reduced escalation of tariffs that otherwise would have been the result of the descending Customs duty ceiling. At the same time large numbers of tariff reductions for specified uses or users have been made, mainly on raw materials and components used as inputs, and on machines. The first of these trends is reflected in the large number of Bangladesh's tariff lines with very high total protective rates, and both the first and second are reflected in the very wide dispersion of total protective rates, which in 2003/04 was considerably greater than in the mid-1990s.

Protection and domestic taxes. In all the South Asian countries the share of revenue collected from VAT-style indirect taxes on imports has greatly increased relative to the revenue from Customs and other protective taxes on imports. Provided that these indirect taxes are collected with equal efficiency at the same rates from domestic producers, this is a highly desirable development since in that cases the taxes are broadly neutral and do not favor domestic production. However, if tax collection in the domestic economy is less comprehensive and rigorous on domestic production than on imports, to an unknown and probably haphazard extent the VAT-style indirect tax may operate as another protective import tax. There is an equivalent issue with "advance income taxes" that are levied on both imports and domestic sales in Pakistan and Bangladesh.

Agricultural tariffs. A striking feature of South Asian tariffs is the very high average levels of agricultural tariffs in India, Bangladesh and Sri Lanka, which in one comparison respectively ranked seventh, tenth and twelfth among developing countries. India's average agricultural tariffs are now just slightly below agricultural tariffs in Tunisia, Turkey, Korea, and Morocco. Many have been increased substantially since general import licensing was removed in April 2001, and this has been done even though some of the products are being exported (e.g. tea and coffee, where the protective tariffs are 100 percent) and even though actual differences between domestic prices and world prices of others are much less than the tariffs imposed (e.g. wheat and common rice, where tariffs inclusive of SAD are respectively 50 percent and 87.2 percent, even though domestic prices in recent years have generally been lower than import prices). Consequently, except for some products (e.g. Indian edible oils), in India and Bangladesh, high agricultural tariffs do not reflect generally high production costs: they rather seem to be precautionary measures aimed at maximizing self-sufficiency and continuing insulation of agricultural, livestock, and associated food processing industries from even the slightest disruption from low priced imports. Unstable world prices for many agricultural commodities and the perception of continuing high protection and subsidies for agriculture in the developed countries, reinforce these policies and undercut domestic proponents of lower tariffs and more open agricultural import policies. These motives are also important in Sri Lanka, but in this case high tariffs are also protecting very high production costs of marginal farmers producing major crops, in particular rice, potatoes, onions and chilies. By contrast, lower average agricultural tariffs and more open agricultural import policies are now in place in Pakistan, and in Nepal, even though some Nepalese food processing industries receive high protection.

Tariffs and government revenue. As tariffs came down in the South Asian countries during the late 1980s and 1990s the contribution of protective import duties to government revenues diminished as well. The decline was less than proportionate to the reduction in tariff rates, because the share of imports in GDP grew. But by 2001 all the governments were much less dependent on tariffs than they had been 10 years before, whether measured by tariff revenue in relation to GDP, or tariff revenue as a share of total government revenue, total tax revenue, or total indirect tax revenue. Subject to the previously discussed caveat on efficiency in collecting domestic VAT imposts, much of this highly desirable lessening of public finance dependence on tariff revenue has been due to the introduction of trade-neutral taxes, the gradual extension of their scope, and improvements in the efficiency with which they are administered. Nevertheless, this strategic shift from import to domestic taxation needs to continue, as protective import taxes are a major source of distorted incentives and rent seeking behavior. In this regard, comparisons with China are highly pertinent. Here import duties are currently less than 3 percent of total imports, and only around 3-4 percent of total (central and provincial) government tax revenues. This compares with about 18 percent of total imports in India during 2001/01, and 9.5 percent of total central and state tax revenue. In 2000/2001 protective import taxes were estimated to account for 31 percent of total tax revenues in Nepal and 27.5 percent in Bangladesh. In these countries, extension of the scope and the base for domestic taxes and improvements in tax administration, including the administration of the Customs service, will be especially important for sustaining further tariff reductions.

Recommendations on tariffs

The many continuing problems with tariff policies in South Asia suggest that national reform agendas for the future should:

- *Make further substantial "tops down" reductions in the general level of tariffs.* The first priority and biggest economic payoff will be in Bangladesh, but the resumption of tariff reduction programs in India Pakistan, Sri Lanka and Nepal is also needed to reduce very high effective protection levels that are being provided to some industries which benefit from high tariffs on final products combined with low intermediate input tariffs. One danger with this process is that too many exceptions will be made which exclude the production of influential firms and industries from the descending ceiling. Another danger is that lower level input tariffs will also be reduced, thereby maintaining effective protection levels. On the whole, however, the extent to which has happened in South Asia has been limited, due to government revenue concerns, and pressure from local producers of intermediates. Consequently, with the notable exception of Bangladesh, for the most part the "tops down" process has, as intended, squeezed processing margins and created more uniform as well as lower tariff structures.
- *Eliminate protective import taxes other than Customs duties.* India's abolition of its Special additional duty (Sadd tax) in February 2004 was a major and highly desirable simplification of its import regime. The protective import taxes that Bangladesh, Sri Lanka and Nepal are presently applying on top of Customs duties should also either be abolished as part of general tariff reduction and reform programs, or merged into Customs duties if they are needed for revenue or for other reasons. This should be the principal priority for reform in Bangladesh, which uses one general para-tariff, two selective para-tariffs, and the VAT on imports to provide very high levels of nominal tariff protection to favored local producers in distinctly non-transparent ways. The protective import taxes in Sri Lanka and Nepal are across-the-board and quite low, and their principal purpose is to raise revenue rather to provide extra protection. In both cases it would be economically more efficient if they were also applied to domestic production, either in their present form or as supplements to Sri Lanka's VAT or Nepal's VAT-style indirect taxes. Pakistan should adjust its income withholding tax on imports so that it is neutral and is no longer a means of providing extra protection to domestic producers. It also needs to review its sales tax on imports (a VAT-style tax) to ensure that if there are exemptions, that they are applied in a transparent and equivalent way to imports as well as domestic production.
- *Abolish existing specific tariffs and abjure their future use.* The principal user of specific tariffs in South Asia is India, where most are used to keep out cheap textile fabric and garment imports from China and other developing countries. One by-product of these specific tariffs is that it is very difficult or impossible for India's South Asian neighbors to compete in the Indian market, even with substantial preferential tariff concessions. Specific tariffs are also the principal instrument used to provide high protection to Sri Lanka's import substitution food crops, and are applied to selected products in Pakistan (e.g to edible oils) and Nepal. Except for some applications where the main objective it to raise revenue (e.g. specific duties on petroleum products, alcoholic drinks and cigarettes and tobacco), the purpose of specific tariffs is to provide protection which reduces the impact in the domestic economy of swings in world prices, and to use non-transparent means that frequently gives very high protection, but that does not attract attention owing to the difficulty of calculating *ad valorem* equivalent rates.
- *Resist making exceptions for particular industries to general tariff ceilings, especially as those ceilings come down.* This is a special problem in India and Bangladesh. In India, the entire agricultural sector was excluded from the reduction in the maximum Customs duty rate from 30% to 25% in the 2003/04 budget, and from the subsequent reduction to 20% in February 2004. There are also a large number of ad valorem duties, and specific duties with ad valorem equivalents,

which greatly exceed the general ceiling rate It is also a major problem in Bangladesh, where many local industries have been given very high tariff protection at rates well above Bangladesh's general ceiling by the use of para-tariffs and VAT exemption for domestic producers. It is also a problem in Nepal, where a number of local industries are protected by tariff rates well in excess of its general 25% maximum.

- *Try to contain pressures for high agricultural tariffs.* As already noted, these pressures are most apparent in India and Bangladesh, where average agricultural tariffs are now well above non-agricultural tariffs, and where large tariff increases at the first sign of import competition are being routinely given. Similar tendencies are also apparent in Sri Lanka for rice and some other large import-substitution crops.
- *Move towards more uniform tariff structures.* Tariffs in South Asia are still very escalated i.e. they go up according to the degree of processing. Despite this, the reduction of the top rates has reduced the extent to which effective protection varies as between different activities. Therefore, as recommended previously, the main thrust of tariff policy should be to press ahead with further "tops down" tariff reductions and a by-product will be further reductions in the variance of effective protection.
- *Reduce and if possible eliminate the use of exemptions and partial exemptions from standard tariff rates.* This continues to be a major problem in India and Bangladesh. Apart from the increases in effective protection that result from the exemptions, the system is complex, opaque and gives excessive discretion to the officials that negotiate and recommend the exemptions. The recent experience in Pakistan shows that "tops down" tariff reductions which also involve reduced raw material, intermediate input and machinery tariffs, will eventually substantially reduce the demand for tariff exemptions.
- *Pay special attention to the potential protective effects of domestic taxes which in principle are collected both on imports and domestic production.* This needs further systematic investigation in all the South Asian countries to see whether and to what extent some of the apparent reductions in protection for domestic industries resulting from tariff cuts, may have been spurious owing to imperfect or non-collection of domestic VAT-style and other taxes from domestic producers. At present the shares of imports and domestic production in indirect tax revenues are generally not reported: this distinction ought be routinely made and trends monitored. The main indirect taxes involved are VATs and VAT-style taxes, but other taxes which are applied to both imports and domestic transactions could also be important, especially the advance income taxes used in Pakistan and Bangladesh.
- *Continue efforts to extend the scope and the base for domestic taxes and to improve tax administration, including the administration of Customs services.* This is critical for sustaining further tariff reductions and is a generally accepted principal throughout South Asia. To monitor how fast and effectively the South Asian countries are in fact freeing themselves from their dependence on protective import duties, it would be necessary to have a systematic look at the sources of the domestic taxes which are replacing import duties, checking in particular that they are not coming disproportionately from imports. It is recommended that this should be a normal part of the financial reporting responsibilities of Finance ministries and of IMF and World Bank monitoring of the tax and public finance situations of the South Asian countries. In particular, Finance ministries should focus on this aspect of their tax policies by distinguishing and regularly reporting the breakdown of the various taxes that are collected by Customs.
- *Engage and make the case for tariff reduction and simplification with the business, farmer and other interests groups that are directly affected.* In arguing this case for tariff reduction and rationalization policies, the main points that are likely to be most easily understood and accepted by the official-business-farm-politician groups that will need to support or at least accept the changes are: (1) low tariffs are needed for local industries to be internationally competitive; (2) low tariffs "even the playing field" with export industries; (3) low tariffs simplify Customs clearance and

reduce incentives for corruption and smuggling; (4) low tariffs make export tariff exemption/drawback mechanisms easier to manage; (5) lower tariffs across the board lead to lower exchange rates which offset some of the tariff reductions and help exporters. Of course, lower tariffs also benefit final consumers, but, regrettably, in South Asia as elsewhere, except for some basic agricultural commodities, the reality is that this general final-consumer (as distinct from intermediate business consumer) interest in low tariffs has practically no weight in discussions and negotiations on tariff levels.

Anti-dumping

The WTO agreements on anti-dumping (AD), countervailing duties (CVD) and safeguards provide three GATT-legitimate justifications for giving extra protection against imports at rates which exceed bound tariffs. South Asian exports have frequently been harassed by both AD and CVD measures, mostly in developed countries, but none of the South Asian countries used anti-dumping until India started in 1992/93. Pakistan's first AD case was decided in November 2002. Anti-dumping is not being used in Bangladesh, Sri Lanka or Nepal, although there are strong pressures to do so. The lack of interest in anti-dumping in earlier years was the consequence of the highly protectionist policies that were followed, which obviated any need for other ways of keeping imports out, but as QRs were removed and tariffs reduced, AD was seen as an alternative GATT-legitimate way of providing protection.

In India the use of AD accelerated after the East Asian financial crisis in 1997/98 and the final removal of traditional import licensing in April 2001. India is now one of the most active users of AD in the world. The most targeted country by far has been China, followed by EU, South Korea, Japan, USA, Taiwan, Singapore, Russia, Thailand, Indonesia and Brazil in that order. AD duties, which come on top of normal import duties, are currently being applied to a wide range of intermediate materials and inputs, including chemicals and petrochemicals, pharmaceuticals, synthetic fibers, and steel and steel products. In the past few years, anti-dumping is increasingly being used against imports of consumer goods. By contrast, no CVD and relatively few safeguards cases have been initiated. Most industries prefer AD to safeguards, because it is generally more easily obtained, more protective, and longer lasting, and is also preferred by most administering government authorities, since unlike the safeguard rules, the AD rules contain no provisions for compensating the affected exporting countries.

AD may act as a safety valve which allows a government wishing to reduce the general level of protection to accommodate lobbying and political pressures which might otherwise build up and compromise the general program. This is an important motive in India and has been a consideration behind the introduction of AD in Pakistan. But whether the use of AD is on balance justified economically then depends on how frequently the safety valve is used and on the economic costs involved, as against the benefits of the trade liberalization that the safety valve makes possible. In order to make this judgment, there would need to be some knowledge and understanding of the economic consequences of the AD activity, but in Indian debates on economic policy there is very little awareness of the scope of the AD that has been occurring, let alone general knowledge of its economic effects. For a number of reasons these effects are likely to be serious and highly adverse.

- The foreign firms targeted and penalized by the anti-dumping cases are almost always those that are most competitive and have the largest and/or fastest growing market shares among exporters to India. In some cases the firms appear to have been following normal business practices and initially selling at a discount to establish themselves in the market, but in most cases they have been selling at prevailing world prices, and the AD duties are in practice an extra import duty on top of normal import duties, not a tax that brings up the export prices of the affected firms to the prevailing normal level of international prices. In both cases the signal to other exporters is to charge "reasonable" prices or also face anti-dumping actions, and results in a real terms-of-trade loss to India.

- The anti-dumping cases have been greatly increasing the protection of industries producing numbers of important and widely used intermediate materials. The ad valorem equivalents of AD duties vary from about 10 percent to 80 percent, but most are in a range of approximately 20 to 50 percent, implying total import duties on imports from foreign firms subject to the AD duties mostly in a range of roughly 40 to 70 percent.
- The increased protection and prices of intermediates are likely to have increased the production costs of consumer goods just as India was being obliged to remove import licensing, and has been providing arguments and pressures for higher consumer good tariffs, many of which are not constrained by WTO bindings.
- The anti-dumping cases have been reinforcing the market power of highly concentrated Indian industries e.g. a study of AD cases up to mid-1999 indicated that of 19 products subject to anti-dumping cases in which information is provided on the structure of the Indian industry, for 11 products there was only one Indian producer.
- New bureaucratic bodies have been created which have considerable discretionary power over India's trade policies, as well as a whole new specialized service industry of accounting and economic consultants, technical specialists and lawyers. While formally quite transparent, the system is *ad hoc* and distinctly non-transparent in fundamental respects, and has created uncertainty for Indian importers and foreign exporters, and many incentives for rent-seeking behavior.
- The extra protection currently being given to domestic industries by Indian anti-dumping measures is increasing the already considerable vulnerability of Indian manufacturing industries to anti-dumping actions in their export markets. AD duties in India, added to already high tariffs, allow local firms to increase their domestic prices and thereby increase the" dumping margins" which are the basis for AD duties imposed on Indian exports elsewhere. Even industries which are not themselves protected by AD duties may become more vulnerable, to the extent that they raise their domestic prices to offset increases in the prices paid for material inputs which are affected by anti-dumping duties.

Recommendations on anti-dumping

The AD cases already decided in India and the potential for unrestricted anti-dumping to undermine the liberalization of the trade regime that has been achieved so far, suggest that a review of current AD policies and practice is urgently needed. The present momentum of anti-dumping in India could be stopped or slowed in a variety of ways by one or more of the following means:

- Repealing the AD law and using the safeguards provisions as the main safety valve for responding to protectionist pressures.
- Channeling all or most cases into the safeguard route and maintaining it as a temporary, short term tariff- based instrument to provide extra protection to firms while they adjust.
- Incorporating a buyer/consumer interest in the AD and safeguards laws, and requiring cases to be decided on the basis of the overall economic costs and benefits of imposing duties.
- Explicitly including an anti-trust type filter in the AD law, which would make predatory pricing and the likelihood of subsequent market power a precondition for the imposition of AD measures.

Finally, an unfortunate consequence of anti-dumping activity in India is that producer groups looking for ways of obtaining extra protection in the neighbouring South Asian countries are using this as another reason why their governments should introduce AD laws and develop the technical capacity to implement them. In these discussions the economic costs of doing so are almost completely lost or ignored: all that is being heard is that AD is a legitimate WTO-sanctioned way of dealing with "unfair" foreign competitors, and that AD can act as "safety valve" to support more general import liberalization objectives. The willingness and interest of various international and national organizations to provide technical assistance to establish AD capabilities in developing countries, makes succumbing to pressures to do so much easier.

So far there are no systematic economic evaluations of the consequences of Indian anti-dumping. Some applied, policy oriented empirical research on this topic could provide a background which could perhaps at least lead to some public questioning of AD in India, and which could be salutary for other South Asian governments presently under pressure to go down the same path.

Export policies

One very important motive for the trade liberalizations that have occurred in South Asia and that are still in process, was the belated recognition that the South Asian countries had missed out on the spectacular export and general economic expansion that had benefited in particular East Asian and South East Asian developing countries during the 1960s, 1970s and 1980s. This point was underlined, especially in India, when it became apparent that China's example showed that export oriented economic growth was possible and feasible even for very large countries. There were corresponding changes in attitudes to the role of exports and to export policies, with a strong policy commitment to exports as a growth engine at a very early stage in Sri Lanka during the late 1970s, slower recognition and later policy commitments in Pakistan, Bangladesh and Nepal, and despite the installation of an extremely elaborate export incentive and promotion apparatus, very slow change in basic understanding and attitudes in India.

This increased recognition in South Asia of the positive role of exports in economic growth, has led to much greater scrutiny of, and efforts to streamline existing export policies and mechanisms, and to new export-friendly initiatives. Most of these initiatives have had important benefits for other aspects of the economy, not just exports. In particular:

- It was recognized that drawback and other duty neutralization schemes were often cumbersome, slow, involved high transaction costs for exporters while not fully refunding or exempting duties on imported inputs, had inadequate product coverage, and were subject to abuse. The general response was to increase the scope of the schemes and broaden their coverage, to build in checks against misuse, and to pay attention to the efficiency of the Customs and other government services involved.
- Direct investment and other roles by foreign firms in export sectors was seen as a fast and effective way of acquiring the production and marketing skills needed for successful exporting. This was especially important in the development of the garment export industries in Sri Lanka and Bangladesh. The key role of foreign firms in accelerating export growth contributed to more supportive general attitudes towards FDI and other forms of foreign participation in the South Asian economies.
- To speed up the development of the special skills and capabilities needed for successful exporting, a wide range of supportive export promotion policies and institutions were established. These covered things such as support for export marketing, the provision of market intelligence, technical assistance and training, quality testing and assurance programs, and increasing the availability of pre-shipment and post-shipment credit.
- The efficiency of Customs services became a major concern. It was recognized that while highly inefficient Customs operations were generally good at keeping imports out, they were also responsible for keeping exports in. This concern for efficient, transparent and faster Customs clearance in the service of exports, was an important motive behind Customs reform programs initiated at different times in all the South Asian countries. These reforms still have a very long way

to go, but they can have major general economic benefits beyond the benefits to exporters, most directly in reducing transaction costs and delivery times for all importers, increasing import competition in the domestic economy, and reducing government revenue losses in the face of declining tariff rates.

In support of these objectives, but also reflecting considerable inertia inherited from past policies, the South Asian countries are now operating a large number of extremely diverse and not always internally consistent policies which affect exports. They can be grouped into (i) policies that restrict exports, such as export controls and export taxes; (ii) policies that subsidize exports, both directly and indirectly; (iii) import duty neutralization schemes, that exempt or refund import duties on inputs used by exporters; (iv) export zones and bonded warehouse schemes that provide duty exemption and other benefits in one package; (v) export promotion and quality control policies and organizations; and (vi) export incentive and promotion schemes tailored for particular products or industries.

India has the most comprehensive and complex set of export policies. This is because, compared to the other countries, it has a much larger and more diversified economy, that it has been slower to liberalize its import regime, and that its import policies are consequently more protective and comprehensive. At the other extreme, Sri Lanka's export regime is fairly simple, reflecting its generally low tariffs on intermediates (including free trade in textiles) and capital goods, absence of QRs, and export specialization, especially in garments and plantation crops. Of the other three countries, corresponding to similar differences in their import policies, the most complex and comprehensive export regime is in Bangladesh, followed by Pakistan and Nepal.

Despite the emphasis on export facilitation and promotion, a surprisingly large number of products are still subject to restrictive export policies. These include export bans and licensing, government export monopolies, and export taxes. Most of the direct controls are in India and Bangladesh: there are only a few in Pakistan, Sri Lanka and Nepal. The major motive is to ensure local availability and suppress domestic prices, either in the interests of final consumers (e.g. onions and pulses in India and Bangladesh) or domestic intermediate consumers (farmer purchasers of subsidized fertilizers in India), or of indirectly subsidizing exports of products further down the production chain e.g. Bangladesh's ban on the export of animal hides and skins subsidizes production and exports of processed leather products. There are also export taxes on some products in India and Pakistan, and Nepal imposes export taxes on 23 products and in addition a general export tax of 2.75% consisting of a 0.75% turnover tax and a defense tax of 2% imposed in 2001.

Across-the-board direct export subsidies are no longer being used, but *ad-hoc* direct subsidies and a large variety of indirect export subsidies are employed, especially by India, Pakistan and Bangladesh. For example, since early 2001 India has been subsidizing exports of large excess stocks of wheat and rice; Bangladesh subsidizes exports of garments which use domestic fabrics; Sri Lanka subsidizes exports of chicken meat; Pakistan provides a general 25% freight subsidy; India, Pakistan and Bangladesh provide transport and marketing subsidies to agricultural exports. Other indirect export subsidies are through directed credit and credit subsidies, government export credit guarantee funds, income and corporate tax exemptions or reductions linked to exports, and grants and other subsidies to small and medium exporters.

Overall, the general trade policies and the export policies of the South Asian countries have become much more supportive of the participation of their exporters in world markets than they were during the earlier import substitution period. The crucial policy developments behind this change have been the liberalization of import regimes through the removal of QRs and the reduction of tariffs, and the provision of facilities for exporters to enable them to operate outside or bypass the import regimes. Other government pro-export initiatives such as the activities of export promotion organizations have also been helpful, but conducive trade policies are a necessary condition for these to be effective. As a result of these reforms, anti-export bias in manufacturing, agriculture and for services, understood as incentives for exports relative to incentives for import substitution production, has declined substantially throughout the region.

Nevertheless, anti-export bias is still a serious concern, especially in Bangladesh. Following its recent tariff reductions, it has declined but is still a concern in India, and also (although to a lesser extent) in Pakistan, Sri Lanka and Nepal, where import regimes are less protective and complex. As long as there is tariff or other forms of protection for production to supply domestic markets, even if export mechanisms and institutions such as drawback, duty exemption for exporters and export processing zones were to operate smoothly without transaction costs for exporters, overall the incentives for exports are generally lower. This has been frequently demonstrated by empirical studies in South Asia, most recently by a comprehensive firm-level study in Bangladesh which found much higher effective protection rates for domestic market production than for exports.

Another concern is that the multitude of duty neutralization schemes and institutions, export restrictions and taxes, direct and indirect export subsidies, export promotion initiatives and other policies have a very uneven but unknown incidence as between different export activities, and could be creating inefficiencies within the export sectors.

In practice the transaction costs for exporters that use duty neutralization schemes can be considerable, and in a system with high and complex protective tariffs and other instruments, export policies and mechanisms which provide for exemptions and refunds so that exporters can function profitably, have been a major focus for lobbying and corrupt practices, involving both the Customs service and the other government agencies responsible for the export policies. These rent seeking activities generate various checks and controls, which in turn slow down and reduce the accessibility of the system, especially for small and new exporters. Despite improvements in the administration of these schemes, aided most recently by the introduction of computer technology and internet links, a recent (2001) official Indian report makes it clear that serious administrative problems remain, with complaints of delays and harassment by Customs officials on the part of exporters, complaints from Customs officials of dishonest practices by businessmen involved in exporting, and conflicts between Customs and Ministry of Commerce officials. In 2001 there was major corruption scandal in India involving falsely documented export containers shipped in order to obtain export incentive payments, and similar large scale corruption scandals involving Bangladesh's export incentive system have also been reported e.g. in 2002 an investigation that is alleged to have involved a number of non-existent textile mills that obtained export subsidies based on non-existent exports. These episodes indicate that as long as there are economic rents inherent in export incentive systems, there are likely to be continuing problems in one form or another. ***The surest way to reduce their severity and the brake they constitute to export expansion, is to continue to liberalize imports and to reduce the protection of the domestic market, thereby reducing the incentives for misuse and rent seeking behavior.***

Recommendations on export policies

The environment for exporters in South Asia has greatly improved with the general trade policy, export policy and institutional reforms that have been implemented during the past 25 years. Nevertheless, there are economic inefficiencies associated with current policies which should continue to be addressed. These are most marked in India and Bangladesh as a result of their complex protective structures, less so in Pakistan and Nepal, and are less serious again but still a concern in Sri Lanka. It is suggested that the appropriate ways to deal with these inefficiencies may include the following:

Remove non-tariff barriers to imports and reduce tariffs. This is fundamental and by far the most important single pro-export reform because (i) it increases the relative attractiveness for businesses to invest and produce for export rather than for the domestic market; (ii) the resulting increases in imports will tend to devalue the exchange rate and make investing and producing for export more attractive than it otherwise would be; (iii) import duty neutralization schemes are easier to manage and involve lower transaction costs the lower are the tariffs that need to be rebated or exempted; (iv) with lower input tariffs, excessive or inadequate exemptions or refunds will create smaller differences between the net incentives for different exported products; (v) lower input tariffs and therefore lower drawback and other rebates reduce the incentives for negotiation between exporters and their agents, and Customs and other officials, and at the same time reduce the incentives for corrupt practices such as over-invoiced or misclassified export shipments.

Set and stick to firm upper limits to domestic market protection and subsidies. This means resisting pressures to make exceptions to general rules by providing extra protection or subsidies above general norms. Otherwise, if it is known that policymakers can be easily persuaded to help with extra *ad hoc* incentives for supplying the domestic market, investors will find this kind of investment more attractive than the risks and difficulties they are likely to face in export markets. In this regard Bangladesh's para-tariffs are probably especially damaging for investment in efficient export expansion, since their proliferation suggests that there has been little resistance to their introduction. Hence, reining in the use of the para-tariffs should be a major priority for the country's export growth and economic expansion.

Reduce the complexity of the tariff and import tax structure, especially by eliminating import taxes other than Customs duties. Together with tariff reduction, reforms to simplify tariff structures reduce the administration and transaction costs of import duty neutralization schemes for exporters, and reduce the advantages of and need for special arrangements and institutions such as export processing zones, bonded warehouses etc

Abolish or phase out non-tariff barriers to exports. Leaving aside restrictions that are imposed for religious, cultural, environmental and similar reasons, most non-tariff export restrictions imposed to influence trade and production are in India and Bangladesh. Like non-tariff import barriers, there are sound economic reasons that they are proscribed (with some exceptions) by the GATT. In South Asia, they are generally crude and non-transparent techniques for subsidizing consumers, or more often inputs used by domestic producers including exporters. In the latter case careful analysis will usually show that they provide excessive but also variable and unreliable indirect subsidies to downstream producers accompanied by a variety of transaction and spillover costs e.g. leather and shoe producers using animal hides the export of which is banned, or furniture producers using local logs and timber the export of which is banned or restricted. There are generally substantial net economic benefits from abolishing them, and if for some reason the subsidies they confer are to be maintained, it is generally better to do this by the use of *ad valorem* export taxes rather than by the use of discretionary controls. In some cases, however (e.g. India's ban on fertilizer exports) the restrictions are part of a set of much more far reaching policies and changing or removing them would need to be considered in the context of more general reforms of these policies.

Abolish or phase out export taxes. The export taxes currently being used in South Asia (e.g. in Nepal) provide a simpler and more efficient and transparent means of achieving some of the apparent objectives of export bans and controls, but like export NTBs careful analysis will almost always show that their economic costs exceed their economic benefits. It is very difficult to make a convincing case for export taxes, whether applied to just some products or across-the-board, if, as is true in all the South Asian countries, incentive systems are already heavily biased against exports. As with export NTBs, there should be a presumption favoring their abolition, unless a convincing argument can be made to retain them in individual cases.

Ensure that efficient mechanisms are in place to exempt or refund VAT- style and other indirect taxes on exported products and on inputs used by exporters. Even if tariffs are reduced to low levels or to zero, there is still a need to free exports from indirect taxes which will generally still be charged on imports and domestic transactions even under free trade. It is important that this is achieved smoothly either through the domestic indirect tax administration or by allowing for these taxes in prior exemption, drawback and other arrangements managed by Customs.

Avoid using direct export subsidies and cut back on the use of indirect export subsidies. There is general theoretical case for paying export subsidies on the grounds that they are needed to make exporting more attractive by balancing the protection to import substitution production resulting from tariffs, but this would require across-the-board subsidies applicable to all exportables (including agricultural and mineral products) comparable in scope to typical tariff schedules that tax all imports. Since export subsidy policies of this scope are economically and political infeasible and have never been attempted (certainly not in South Asia), a much more efficient, simple and effective way of reducing the disparities between import substitution and export incentives is to reduce tariffs. In addition, as employed in South Asia, both the direct and indirect export subsidies are being applied unevenly to a limited range of products in a haphazard manner, creating large and economically inefficient disparities in the net export incentives (effective rates of subsidy) between products. Many also involve high administration and transaction costs relative to the subsidies that are disbursed (e.g. subsidized export credit, export tax holidays, subsidized export credit guarantees, matching grants for new exporters, transport and marketing subsidies) as part of efforts to limit their misuse and diversion to non-export activities. It is also highly relevant that export subsidies are banned or discouraged by WTO agreements, for good reasons as they both disrupt world trade and are generally not in the interests of the countries which pay them.

Finally, like other developing countries, the South Asian countries have an interest in supporting not only rhetorically but by their own policies, the efforts embodied in the WTO agreements and negotiations to reign in developed country export subsidies and to reduce the danger of future international export subsidy wars in which they could not hope to compete with the developed countries. In this regard India's big export subsidies during the past few years on large volumes of wheat and rice exported from its government held surplus stocks, seem to be violating the spirit of one of the key elements of the Agreement on Agriculture, and to be compromising India's own medium and long term interest in more open and less distorted world markets for these and other agricultural commodities.

Regional Trade and Preferential Trading Arrangements

With the exception of the trade of Nepal and Bhutan with India, and the trade of the Maldives with Sri Lanka, South Asia's past import substitution trade policies restricted intra-regional trade even more than trade with the rest of the world. Following independence from British rule, trade of the newly independent countries with each other fell from about 19 percent of their total trade in 1948, to around 4 percent by the end of the 1950s and to only 2 percent by 1967. This very low share only began to increase during the 1990s, as the general trade policy liberalizations in the individual countries began to take hold.

There are a large number of multilateral and bilateral regional trade agreements (RTAs) in South Asia: the Bangkok Agreement, the South Asia Preferential Trade Agreement (SAPTA), and the India-Sri Lanka, India-Nepal, India-Bhutan, and Bangladesh-Bhutan trade agreements. The Bangkok Agreement includes India, Bangladesh and Sri Lanka, and also four non-South Asian countries, Thailand, Republic of Korea, Laos and China (the latter since 2001). However, the size and scope of preferences have been very limited and it has had practically no impact on trade between the member countries.

For a number of years, there were discussions on a bilateral FTA between India and Bangladesh, and another between Pakistan and Sri Lanka. Following a number of years of negotiation and delays, improved relations between India and Pakistan led to the signing of the South Asian Free Trade Agreement (SAFTA) in January 2004. It is planned that SAFTA's trade provisions will come into force in January 2006 and that they will be fully implemented by December 2016. In the meantime the SAPTA and various other RTA commitments are to continue alongside whatever is done under SAFTA.

Until about end-1998, the regional trade agreements (RTAs) involving the larger countries had minimal impact on regional trade. The only arrangements which have supported large volumes of trade for peripheral countries have been India-Nepal and India-Bhutan. But this trade has been tiny in relation to India's total trade. The reasons for the minimal impact during earlier years of the RTAs on trade between the larger South Asian countries have included:

- The extreme reluctance to make any meaningful concessions in the earlier years (e.g. Bangkok agreement, the first SAPTA rounds)
- The political problems between India and Pakistan, exemplified by Pakistan's positive list of products which can be imported from India. This relationship has hamstrung SAPTA and led all the South Asian countries to look for bilateral free or preferential trade agreements with each other.
- India's import licensing system which (except for a few bulk commodities which were imported by parastatal monopolies) continued to effectively ban imports of all consumer goods from all destinations. The ban was lifted (for the SAPTA countries only) in 1998. It finally disappeared for the rest of the world in April 2001.
- The controls of India's agricultural parastatals over imports and exports of major primary commodities

Regional trade expanded rapidly during the late 1980s and 1990s, principally due to unilateral trade liberalization by the South Asian countries on India's periphery, and large appreciations of the exchange rates of the peripheral countries relative to the Indian rupee. Most of the increased trade was one way, with large increases in exports from India, especially to Bangladesh and Sri Lanka, but it had little or nothing to do with regional tariff preferences. Since 1999, however, the potential for RTA-induced increases in regional trade has increased, mainly due to:

- the increased product coverage of SAPTA concessions,
- the abolition in August 1998 of India's consumer good QRs on imports from SAPTA countries.
- the India-Sri Lanka Free Trade Agreement (FTA)
- in the longer term, SAFTA

Since the late 1990s, the expansion of regional trade has continued, but at a considerably slower rate, and as during the 1990s, it has mostly consisted of exports to the peripheral countries from India. Since the signing of the bilateral India-Sri Lanka FTA (ILFTA), Sri Lankan exports to India have increased quite rapidly, but from an extremely small starting point. Overall, in absolute terms, there have been only minor increases in Indian imports from the other South Asian countries during the past five or six years, and the share of the peripheral countries in India's total trade remains tiny (about one percent) and has not increased during the past six years.

However, the increased regional formal exports from India, most of which have been subject to normal MFN tariffs or very low preferences, has improved economic welfare in the region, especially in

Bangladesh and Sri Lanka, and in India as a result of the expansion of Indian exports. Many imported Indian products are better adapted to the requirements of buyers in the other South Asian countries than imports from outside the South Asia region. But nearly all the increased trade has been in products for which there are no or few preferential tariffs under SAFTA or the other RTAs. This is because Bangladesh's tariff preferences are very small and cover only a limited number of products, while Sri Lanka's preferences are more extensive and larger in proportional terms, but are mostly allowed on products for which MFN tariffs are already very low. India has provided much larger proportionate preferences over a wider range of products (both under SAPTA and the bilateral FTA with Sri Lanka), but for reasons that are not well understood, the import response has been very minor. Possible reasons include rules of origin constraints, quotas on some key products of interest to Sri Lanka, and various informal and transaction costs in clearing Indian Customs , but more general factors including supply constraints in the peripheral countries and highly competitive conditions in some Indian domestic markets are probably more important.

Because many tariffs in the region are very high, especially in India and Bangladesh, there are large potential trade diversion costs for the region as a whole if the various preferential trade agreements including SAFTA were to be implemented in a comprehensive way. The consequent reductions in economic welfare would show up principally in reduced customs revenue and terms-of-trade losses. It is unlikely that benefits through increased competition, economies of scale, or improved operating efficiency of import competing firms would outweigh these overall economic costs. There are much larger gains from increased trade with the rest of the world (ROW), especially trade with the developed countries and with more advanced developing countries in South East and East Asia, including China. This is because the South Asian countries have comparative advantage in relation to ROW in similar, mostly labor intensive products, and the volume of trade and the economic benefits from trading these products among themselves are limited by comparison.

For all these reasons the South Asian countries as a group would do much better economically if each of them were to give first priority to increasing their trading integration with the rest of the world, rather than to the pursuit of regional preferential arrangements. The way to do this would be to reduce their tariffs and other forms of protection generally on an MFN basis, thus increasing the shares of both imports and exports in their economies, including imports and exports from their neighbors. This would also reduce the likelihood of economic losses and improve their individual prospects of benefiting from regional agreements to which they are committed, in particular SAFTA.

It is possible that individual South Asian countries might benefit from more thoroughgoing regional preferential arrangements, even if the region taken as whole might lose. Insofar as regional preferential trade arrangements such as ILFTA and SAFTA continue and become effective, a South Asian country that liberalizes and moves to lower general (MFN) protection levels (e.g. a country such as Sri Lanka) would also lose less from the preferential arrangements, and could stand to gain substantially on balance if other South Asian countries (e.g. India) remain highly protected and are willing to accord significant preferences to imports from the region. This could happen if political considerations favoring preferential arrangements override economic considerations, in the case of countries which open up to preferential imports from the region even though remaining highly protected viz a viz the rest of the world. Otherwise, it is perhaps unlikely to occur, since the same industries and interests that resist reductions in general protection levels are likely to also resist reduced protection against imports from RTA countries. Hence it would be a tactical mistake for countries such as Bangladesh to delay general trade liberalization in the hope that doing so would improve their eventual access to, and the tariff preferences they receive, in the markets of protected RTA member such as India.

Although the overall economic benefits for the region as a whole, of increased regional trade spurred by tariff preferences are doubtful, the removal of barriers which explicitly discriminate against regional trade would unambiguously improve regional economic welfare. An example is the Pakistan ban on all imports from India except for products on Pakistan's 677-item positive list and by measures on both sides that restrict transport links, business travel, and business contacts of all kinds. Removing this discrimination would increase economic welfare in both countries. To take a single example, periodically (as during 2000/2001) Pakistan imports wheat from world markets rather than buying from the large surplus stocks nearby in India. Selling these stocks to Pakistan could reduce prices and benefit Pakistan consumers, while at the same time increasing economic welfare in India by reducing the subsidies involved in exporting surplus wheat to other countries and reducing the costs of holding wheat stocks, including the cost of the substantial quantities of wheat that are lost in substandard storage. Rice exports from India to Bangladesh in equivalent circumstances have benefited both countries, and more generally, the whole region would benefit from region-wide markets in grains and other commodities, provided that trade with the rest of the world were also open and unimpeded.

A 1996 GOP study found that the economic benefits to Pakistan of removing this impediment to trade with India would outweigh the costs. Two principal groups, consumers (lower prices) and the government (greater customs duty revenue from legalizing illicit border trade), would benefit from such liberalization. Important segments of producers would also benefit because of increased competitiveness and market access to the much larger Indian economy. Inefficient producers would need to restructure and increase competitiveness to stay in the market.

More generally, initiatives to facilitate regional trade by improving such things as transport links, communications, market intelligence, regional trade financing, Customs and internal tax cooperation, regional travel for traders and other businessmen, and many others would clearly be welfare enhancing for the region, whether achieved under SAARC/SAFTA or other auspices. Regional organizations have a key role quite independently and separately from the question of the economic desirability of regional tariff preferences.

Recommendations on regional trade and preferential arrangements in South Asia

- Give priority to trading integration with the world as whole through further general trade liberalization on an MFN basis
- Recognize the potential substantial economic costs to the economy if substantial tariff preferences are given when MFN tariffs are high
- Recognize that there could be potential substantial economic gains for a country from preferential arrangements provided the country's own tariffs are low and the partner country or countries have high tariffs but despite that are willing to provide substantial preferences with non-constraining rules of origin. But also recognize that the same interests that resist general MFN trade liberalization in the partner country are also likely to resist or obstruct substantial meaningful preferences that would create substantial competing imports resulting from the tariff preferences.
- Do not delay unilateral MFN liberalization as a way of obtaining more favorable preferences from regional preferential trading partners.
- When politically possible, remove or reduce sources of positive discrimination against regional trade. Specifically, the SAFTA framework and commitment would seem to provide an opportunity for Pakistan to formally accord MFN status to India by abolishing its positive list of products that can be imported from India, and for both countries to remove restrictions on travel and commercial contacts which hinder trade between them.
- Pursue bilateral and regional initiatives to improve the general conditions for regional trade, including transport, communication, market intelligence, storage, travel rules and facilities, Customs procedures and cooperation, financing and many others.

Special Treatment for Problem industries

"Eyesores" such as Pakistan Steel, the Pakistan auto and motorcycle assembly industries; sections of the steel and urea fertilizer industries in India, and others that have gained large state subsidies and/or high protection against import competition abound in South Asia. In India and Pakistan edible oil processing benefits from such protection, as do textile fabric industries in India and Bangladesh, the Indian and Pakistan auto industries, many import substitution consumer good producers in Bangladesh, rice, potato, onion and chili growing in Sri Lanka. In many cases, the strongest resistance to policy reform comes from public sector firms and government ministries and departments that oversee the PSUs and the industry generally, e.g., in India, the public sector firm SAIL (Steel Authority of India) and the Ministry of Steel; the public sector firm National Textile Corporation and the Ministry of Textiles; and the joint public sector/Suzuki firm Maruti Udyog and the DGFT (Directorate General of Foreign Trade) in the Ministry of Commerce and Industry (responsible for the recently terminated auto local content ("indigenisation") program. As in other countries, the role of Ministries of Agriculture in South Asia is the promotion and protection of the interests of farmers and farming activities. This generally includes all farm and livestock activities, including those receiving high protection, although some farmers will typically have more influence than others, depending on their lobbying strength and political clout.

India's National Textile Corporation (NTC) is a good example of a firm with a large and influential workforce -- over 100,000 workers in about 120 textile mills – that would have trouble adjusting to liberalizing reforms. As an indication of the political sensitivity of adjustment in this industry, during the many years when the Indian textile market was completely insulated from import competition, initiatives to finally close down and sell off the assets of patently unviable NTC mills have either not been pursued or explicitly rejected (e.g. in 2000 at Cabinet level). Another example in India is SAIL, which operates five integrated steel mills, some of which would not be viable with open competition, and which has a total workforce of about 148,000, which far exceeds the appropriate workforce for its total steel production.

In thinking about problem industries and what to do about them in the context of trade policy reform, especially in South Asia, it is important to recognize that high protection through high tariffs may not be protecting correspondingly high production costs, at least in the entire protected sector. For example, auto tariffs in India are 60%, yet the largest domestic producer Maruti and other joint venture car manufacturers have emerged as major exporters to world markets, and domestic ex-factory auto prices for smaller cars in India are low by world standards and appear to be not far out of line with export prices. Likewise, grain and other agricultural tariffs in India are high, but domestic grain prices not far above or below import parity prices. In cases such as these, with greatly redundant tariffs, tariff reductions may involve little of no adjustment of domestic production. If this is the case, as a general principle it is especially important to get very high tariffs down as soon as feasible, because even if most of the industry is competitive, the high tariffs are likely to be sheltering pockets of high cost production, and if maintained for long periods, they have the potential to pull more resources into these and other high cost market segments, increasing the adjustment costs and the resistance to reform if it is put off to a later time.

Where line ministries and other government entities with long established interests in industry controls preside over protected industries, policy reform faces added obstacles. As with any kind of reform, in some circumstances, in order to push trade policy reform effectively, rather than directly threatening the regulatory roles and therefore the jobs of the bureaucrats and the influence of ministers, it may be more effective to attempt to change their roles from regulating the industry to restructuring and promoting it. This appears to be the current strategy in the Indian Ministry of Textiles, for example, which since 1999 has been in charge of a "Technology Upgradation Fund" scheme, which aims to help the power loom section of the industry face up to the MFA phase out and the removal of India's remaining textile and garment QRs which occurred in April 2001. Likewise, the Bangladesh Ministry of Commerce has, though belatedly, completed an in-depth study of the RMG sector, in order to formulate a strategy to face up to the challenge of MFA phase out.

It is critical, therefore, to ensure that what is done in the name of strategic policies for promoting a dynamic sector do not give rise to interventions that actually slow down or prevent the abandonment of old regulatory controls, and do not introduce new types of planning and regulation that primarily expand the role of the bureaucracy.

Recommendations on problem industries

- Do not hold back general reforms such as tariff or subsidy reductions to protect particular problem industries or firms. Rather, go ahead with the reforms and develop separate programs to deal with the problem areas.
- Rather than threatening the existence of Ministries or other government organizations associated with the problem industries or firms, try to give them a role in the adaptation of the industries or firms to the new competitive environment, including restructuring, modernization but also closure and dealing with the resulting employment and other disruptions.
- Where feasible and economically appropriate, help to create conditions in which fast growth of other firms or industries can help absorb some of the employees from the restructured or closed industries or firms.
- Do not delay cutting tariffs or other forms of protection on the grounds that the protected producers are efficient and not using the protection to charge high prices or perform poorly.

Trade policy reform and the WTO

The motivations and original impetus for trade liberalization in the South Asian countries had little to do with the GATT, and reforms got under way well before the conclusion of the Uruguay Round negotiations and the establishment of the WTO in 1995. Nevertheless, since 1995 the WTO rules and institutions have contributed directly to further trade liberalization, have helped tie in reforms once they were made, and have greatly improved transparency and the accessibility of relevant knowledge.

- The dispute in which the US, the EU and a number of other WTO members successfully challenged India's right to maintain a large number of QRs under GATT Article XVIII (B), at the very least hastened their demise, and may have been a necessary condition for them to be dropped at all. A similar, earlier dispute in which a WTO panel found against a number of QRs then being operated by Sri Lanka made it clear, both in Sri Lanka and in the other South Asian countries, that the routine use of traditional QRs to protect local industries was no longer feasible.
- Complaints of other WTO members under the TRIMS agreement, eventually resulted in the removal of local content or "indigenisation" schemes in the Pakistan engineering industries and the Indian auto industry.
- Bindings of non-agricultural tariffs have constrained tariff increases that might otherwise have occurred, principally in India where a fairly large number of tariffs were bound at 25% or 40%, but less so in the other South Asian countries where there have been very few bindings.
- The phaseout of the MFA has motivated efforts to improve the efficiency and competitiveness of the textile and clothing sectors of the South Asian countries through more open and less interventionist policies.
- The WTO Information Technology (IT) Agreement has been a major influence in the removal of QRs and tariff reductions for these products in India, where it has reinforced decisions to liberalize imports of computers and computer related equipment, which was a *sine que non* for the rapid growth of the software industry and software exports

- The Agreement on Agriculture has had little direct impact on national agricultural trade and other policies in South Asia, but has made these policies much more transparent, especially the requirements for tariffs-only protection and to a lesser extent, the reporting requirements on things such as subsidies and price support, state trading and SPS.
- Acceding countries generally face more rigorous WTO membership conditions than established members, and this has affected Nepal, which has bound all its tariffs, both agricultural and non-agricultural, at low levels, and has committed itself to phase out its para-tariffs. Hence Nepal's trade policies are tied in by WTO commitments that are considerably more comprehensive and constraining than the commitments of India, Pakistan, Bangladesh, Sri Lanka and the Maldives. Bhutan is likely to face a similar situation when it eventually joins.
- The periodic WTO Trade Policy Review (TPR) reports are providing extremely comprehensive yet compact descriptions of each country's trade policies and institutions in a consistent framework that permits comparisons with other countries. This is a major advance on the situation before the TPR reports were instituted (see for example the excellent 2002 TPR reports on India and Pakistan). Many new developments in national trade policies in South Asia can be easily followed on the WTO website by looking at the reports required to be submitted to the various WTO committees.

Recommendations on trade policy reforms and the WTO

Although WTO membership involves accepting some external constraints which favor more open and liberal trade policies, for established members the extent to which WTO membership is used in this way is largely up to the countries themselves. The WTO negotiating positions of the South Asian countries have been very mercantilist, resisting pressures for tighter disciplines on their own policies, pressing for exemptions on the grounds of "special and differential treatment" for developing countries, and focusing on further liberalization in the developed countries. One result of the mercantilist orientation of public debate and perceptions of the WTO in South Asia is that many opportunities that the WTO framework provides to promote and tie in more open national trade policies are being missed. In particular:

- Most non-agricultural tariffs in Pakistan, Bangladesh, and Sri Lanka are unbound. It would be in these countries' interests to bind these tariffs at low levels as a discipline against backtracking and arbitrary tariff increases. This also applies to the large number of Indian non-agricultural tariff lines that are unbound.
- Except in Sri Lanka and Nepal and a few products in India, nearly all agricultural tariff bindings in South Asia have been set at very high- to- prohibitive levels. It would be appropriate to substantially reduce them unilaterally and independently of the tariff bargaining that is occurring as part of the ongoing WTO negotiations.
- Bangladesh has on the whole successfully argued that its "least developed" status should permit it to be exempt from most WTO disciplines, even though as a very low income country with high poverty levels, it can least afford to use resources inefficiently. For example, inefficient resource use results from the very high domestic market protection rates for many industries that result from QRs and the use of para-tariffs. While in a very poor country the impulse to support protection and employment in local industries is understandable, doing so detracts from economic growth, diverts resources from more economically efficient and often more employment intensive export industries, and in the case of many of the protected goods, is equivalent to a regressive tax on consumers which runs counter to other policies aimed at reducing poverty. These considerations should have a larger role than they do at present in determining the commitments that Bangladesh is willing to make at the WTO.
- Over the past few years, India's subsidized exports of rice and wheat appear to be openly breaching the AoA rules on agricultural export subsidies, and may jeopardize the agreement itself. As India is a low cost producer by world standards of many major agricultural commodities, it has a long term

interest in the success of agreements such as the AoA, which is a historic attempt to begin opening up world agricultural markets.

- There seem to be very little awareness of the existence, let alone the content of the WTO TPR reports in the South Asian countries, even in universities and research institutes involved in policy related research. Seminars to discuss the content and implications of these reports would contribute to better informed debates and decisions on national trade policies.

Trade Policy Issues in Some Key Sectors

In addition to identifying significant trade policy issues in South Asia and assessing the trade regimes of the five largest countries individually, this study examines the nature and recent (since 1997) evolution of the trade and trade-related policies that affect agriculture, fertilizers and the textiles and clothing (T&C) industries. Agriculture (including livestock, fisheries and related rural activities) still accounts for by the far the largest part of the workforces of the South Asian countries and major shares of GDP. Fertilizers are the principal internationally tradable inputs for agriculture, and in India, Pakistan and Bangladesh, the fertilizer industry is one of the largest in the manufacturing sector. In all five countries, textiles and clothing are far ahead of all other industries in terms of their share of manufacturing employment and of total exports. Therefore the nature of the trade and other policies which affect the performance of these industries is especially important for the acceleration of economic growth which can directly and rapidly benefit poor, skilled and unskilled rural and urban workers. Subject to pressures for adaptation that arise out of global trade negotiations such as the Uruguay Round, the Agreement on Agriculture (AoA) and the phasing out of the Multi-Fiber Arrangement (MFA), agriculture and textiles are sectors where global market trends and opportunities may drive domestic policy even more rapidly in the future than in previous decades.

Agriculture

The report uses the term agriculture broadly to refer to livestock and fisheries as well as farming, and also to food processing industries. Most but not all of the international tradable products produced in these industries are subject to the WTO Agreement on Agriculture (AoA). Bhutan is so far not a WTO member, but Nepal acceded in December 2003, and India, Pakistan, Bangladesh and Sri Lanka participated in the Uruguay Round and as part of their WTO membership signed on to the AoA. But for a number of reasons, signing the AoA has so far had little impact on their agricultural trade policies in the region, because:

- Except for some Indian tariff lines, India, Pakistan and Bangladesh bound nearly all their agricultural tariffs at very high to prohibitive levels (100, 150, and 300 percent). As intended, this has given these countries practically unlimited discretion to increase applied tariffs up to levels which in many cases amount to *de facto* import bans. Only Sri Lanka (all AoA tariffs bound at 50%), and Nepal (average AoA binding on accession 42.3%) face significant WTO constraints on their ability to increase agricultural tariffs
- Agricultural support price p olicies and subsidies have not so far been constrained by the AoA's Aggregate Measure of Support (AMS) rules, in India, Pakistan and Bangladesh mainly owing to low support prices (relative to import prices) for the major food grains, the effects of which outweigh positive support levels for some other crops and the principal agricultural input subsidies (for fertilizers, credit, electricity and canal irrigation).
- State trading import and export monopolies (STEs) are allowed by the GATT, and India has continued to control imports of the principal food grains and some other agricultural commodities in this way. However, it has removed its corresponding STE monopolies over exports, and in the other

South Asian countries (most recently in Pakistan) all STE export and import monopolies of agricultural commodities have been abolished.

- They have signed on to "tariffs only" protection of their agricultural sectors, except for recognized GATT-legal import controls, of which the most important are controls justified under the balance of payments clause, health and safety and technical standards (regulated by the SPS and TBT agreements) and controls based on religious and similar social considerations. However, it is probable that a major motivation for the ways in which some of these controls are being implemented is protection of particular primary and food processing industries, in addition to which some traditional import bans and restrictions are being still being employed, mainly in Bangladesh, but a few also in Sri Lanka and Nepal.
- Another consequence of the AoA was that the South Asian countries agreed not to pay any export subsidies, apart from transport and marketing subsidies until January1, 2004, and apart from the use of normal export mechanisms such as duty drawback etc. Agricultural exports in South Asia have traditionally been restricted or taxed rather than subsidized, and in fact some export controls and taxes on primary commodities still continue, notably in Bangladesh and Nepal. Hence the AoA commitment to not subsidize exports did not initially represent much of a change from previous policies. However it is now becoming much more of an issue, owing to the expiry of the exemption for transport and marketing subsidies, the increasing use of a variety of indirect export subsidies including transport and marketing subsidies, and because of India's disposal since 2001 of large surplus stocks of wheat and rice at heavily subsidized export prices.

Starting in about 1997 or 1998, world prices of some major agricultural commodities, such as food grains, edible oils and oilseeds, cotton, and rubber declined substantially. This has been an important influence behind strong pressures for increased agricultural tariffs and other forms of protection against imports, which have emerged in South Asia since then. These pressures were accentuated in India as a result of the phaseout of its import licensing system between 1997 and 2001: this had covered all agricultural commodities and processed foods and either restricted or banned imports altogether. India, Bangladesh and Sri Lanka have been very responsive to these pressures, but for the most part they have been resisted in Pakistan, which is continuing with a radical (by South Asian standards) liberalization of its trade and trade-related policies in agriculture. There has been little change in Nepal and Bhutan, which with some exceptions have continued their previous relatively open trade policies for their agriculture livestock and food processing sectors.

Some noteworthy features of present South Asian agricultural import policies include the following:

- In terms of the use and level of formal instruments, India's policies appear to be by far the most protective, followed by the policies of Bangladesh and Sri Lanka. By contrast, in Pakistan, Nepal and Bhutan, with some exceptions (notably edible oils in Pakistan and some food processing industries in Nepal), the sectors appear to be quite open to import competition.
- Non-tariff measures are being freely used in India. These are formally WTO-legal (e.g. STEs, TRQs with out-of-quota tariffs below tariff bindings, and the use of health, safety and technical regulations), but protection of local industries is often a major and frequently the predominant motive for using them
- There are many high to prohibitively high "tariff peaks" in India and Bangladesh, and some on major commodities in Sri Lanka, which greatly exceed the general maximum tariff. India's unweighted average agricultural tariff is now (for 2004/05) 40 percent, the fifth highest in the world among 106 developing countries. The equivalent unweighted average protective tariffs in agriculture (including other protective import taxes as well as Customs duties) in Bangladesh (39.8%) and Sri Lanka (28.1%) rank seventh and thirteenth among the same sample of 106 developing countries.

- There are some striking differences between the South Asian countries in the restrictiveness of import policies (i.e. the level of tariffs and the existence of non-tariff measures) which apply to some major commodities, such as rice, wheat, dairy products, pulses, and edible oils. For example, the Indian tariffs on crude palm and refined palm oil in 2003/04 were respectively 65% and 85% (applied to fixed tariff values rather then to actual cif prices), compared to 6% and 18% on actual invoiced prices in Nepal. Very large differences such as these create smuggling opportunities in the region, and in the case of edible oils have led India (in the context of the India-Nepal bilateral trade treaty) to impose quotas on imports from Nepal.
- Large and highly distorting agricultural input subsidies continue to exist in India (for fertilizers, electricity, canal irrigation and credit) and in Sri Lanka (principally for urea and canal irrigation), but have mostly been abolished or substantially reduced in Pakistan, Bangladesh and Nepal.
- In India, Pakistan and Bangladesh, most of the time actual differences between domestic prices and world prices of many agricultural products are much less than tariffs that would be applied to imports (e.g. wheat and common rice, where tariffs in 2004/05 are respectively 50 percent and 70 percent, even though domestic prices in recent years have generally been lower than import prices). Consequently, except for some products, even after allowing for input subsidies, high agricultural tariffs do not reflect generally high production costs: they rather seem to be precautionary measures to ensure that domestic markets are fully insulated from any form of import competition. These motives are also important in Sri Lanka, but in this case high tariffs are also protecting high domestic prices and high production costs of marginal farmers producing major import substitution crops, in particular rice, potatoes, onions and chilies. With this important general exception, and the exception of some heavily protected products such as edible oils in India, Pakistan and Bangladesh, most of South Asian agriculture so far remains economically efficient with low to moderate costs by world standards.

In recent years the South Asian countries have been paying increasing attention to the health and quality standards of agricultural and processed exports in order to meet the SPS standards of importing countries. Generally speaking, however, they are no longer explicitly taxing or using licensing or export bans or quotas as they did in the past to deliberately restrict their agricultural exports and depress domestic prices. The removal of cotton export QRs in India and Pakistan is especially significant, as for many years in both countries these had been used to push domestic cotton prices below world prices, thereby taxing farmers and subsidizing the domestic textile industry. Compulsory parastatal export monopolies have also been abolished, including in India where they had previously been used to prevent or restrict exports of some major commodities, notably common rice. However, there are some exceptions, in particular in India where export conditions for a number of key commodities including common rice, wheat, coarse grains, wheat and coarse grain flours, sugar, bulk powdered milk, and butter are formally "free", but where export contracts have to be registered with APEDA and it is provided that quantitative ceilings can be announced by the Ministry of Commerce (DGFT) "from time to time". Other exceptions are fairly extensive lists of agricultural products in Bangladesh and Nepal the export of which is either banned or subject to export taxes.

The South Asian countries which are WTO members all have zero export subsidy commitments under the WTO Agreement on Agriculture (AoA). However, they are applying their general GATT-legal export policies that are used to promote manufactured exports to agricultural exports. These include the schemes for rebating or exempting import duties on imported inputs that are used in exported products, such as drawback, duty exemption, bonded warehouses, the Indian duty exemption passbook schemes, and export processing zones. India has established a number of specialized agro-industrial zones for exporters. In addition to these, various specialized facilities and subsidies that are generally available to exporters are also being used for agricultural exports e.g. preferential pre-shipment and post-shipment credit lines, export credit guarantee schemes, income and corporate tax exemptions and reductions, and reduced income withholding taxes. India and Pakistan are also paying freight and marketing subsidies (permitted in the case of developing countries by the AoA until January 1, 2004) for a number of primary exports. However, since 2001 India has been selling large government surplus stocks of wheat and rice in export markets for very low prices. These sales are inconsistent with the spirit of the AoA, a fundamental purpose of which is to limit and eventually prevent domestic price support and subsidy policies which create exportable surpluses that are then disposed of by exporting at subsidized prices. Because India is one of the world's largest grain producers and because of the large scale of its export sales relative to world markets (especially in the case of rice) this raises basic questions about the credibility of the AoA agreements and India's own long term interest in open world agricultural markets.

Recommendations on trade policies and agriculture

By world standards, agriculture as a whole in India, Pakistan, Bangladesh, and Nepal, is internationally very competitive, even though there are a few relatively minor (in terms of GDP shares) high cost subsectors which depend on high protection against import competition. Sri Lankan agriculture is very different, with agricultural GDP dominated by high cost and heavily protected and subsidized rice and other import substitution crops, combined with economically efficient plantation export oriented crops which on balance are discriminated against by the incentive system. This makes the liberalization of Sri Lanka's trade and other agricultural policies more difficult than would be the case in India and the rest of South Asia, owing to the greater relative impact on high cost import substitution farmers.

Despite this, a disturbing trend in India over the past few years is that very high protective tariffs are being routinely given to efficient agricultural industries with low costs and prices by world standards, usually with arguments that world prices are low and unstable and that "comfort" tariffs are needed to ensure that imports do not disrupt production and affect the livelihood of large numbers of small producers. SPS, TBT and other formally WTO-compatible techniques are also being used to protect domestic industries. A similar trend has developed in Bangladesh. Experience world-wide, especially in agriculture, is that high protection will sooner or later create high cost production, as land, labor and capital move to produce products protected by high tariffs or non-tariff barriers to imports, at the expense of other products where pro-protection lobbies are less effective. In the protected industries, there are usually efficient producers who earn substantial economic rents after protection goes up, and marginal producers who barely break even, but both groups have a vested interest in the maintenance of the system. Exporters and exports are typically major losers in this process, since they have to compete in world markets without protection. These trends involve potentially high economic costs for producers, consumers and for economic growth in both countries.

More generally, as a low cost agricultural producers, the South Asian countries have a strong interest that the follow-up to the Uruguay Round succeeds in reducing agricultural protectionism in the developed countries and freeing world agricultural markets. In particular, India has one of the world's largest agricultural economies and can directly influence the world markets of many agricultural products. If it follows open, predictable, non-interventionist trade policies it can broaden these markets and reduce their instability, but if it intervenes excessively to protect its domestic market against instability in world markets, it is large enough to further increase international instability, which in turn reinforces protection and intervention in other countries. With the notable exception of its recent subsidized exports of rice and wheat, and also some products subject to export restrictions and taxes, India's agricultural export policies have been relatively non-interventionist and have contributed to more stable international prices, since its exports tend to rise when world prices go up and fall when world prices decline. But the opposite is true on the import side, where there appears to be a broad consensus in India that agricultural import duties should be flexible within the wide bounds permitted by its WTO bindings, so that they can be increased when world prices go down, and decreased when world prices rise. This behavior increases the amplitude of short run world price fluctuations and runs counter to India's own long run interests by retarding progress towards more open and stable world markets.

For these reasons, the economic interests of India and the other South Asian countries would be served by less interventionist and more transparent and stable agricultural trade policies. This would mean:

- In India, Bangladesh and Sri Lanka, substantially reducing both the present very high peak agricultural tariffs and also the general level of agricultural tariffs
- Resisting pressures for new high and highly variable agricultural tariffs
- Taking the initiative to remove existing non-tariff methods of protecting domestic agricultural industries and resisting pressures to introduce new protective NTBs, including especially through the use of SPS and technical regulations
- Reducing their generally prohibitively high agricultural tariff bindings under the AoA to much lower levels, as a way of providing an external constraint on domestic lobbies pressing for high protection
- Removing the present export bans, restrictions and taxes applied to agricultural products, especially in Bangladesh and Nepal.
- Managing domestic support price policies so that they are compatible with relatively low tariffs and open import and export policies, and so that they do not result in the accumulation of large excess stocks, as has occurred in recent years in India with wheat and rice
- Eschewing the use of agricultural export subsidies, both direct and indirect. In this regard, it would be especially important for India to ensure that its present large subsidies for exported rice and wheat do not become a permanent feature of its agricultural trade policies.
- In India and Sri Lanka, removing or phasing out the very large and highly distortionary agricultural input subsidies.

Although strong arguments can be made that this list of reforms would serve the overall economic interests of the South Asian countries, as in the rest of the world, agricultural trade policies are highly sensitive politically, and it is by no means apparent that economic logic can or will prevail over political compulsions. In this regard, efforts in South Asia to reduce protection and other interventions are made much more difficult by continuing high agricultural protection and subsidies in other countries, especially in the EU and the US. For example, the 2002 US Farm Bill helped to undermine protagonists of more open agricultural trade policies in India. Unless there is a major change in the direction of developed country agricultural policies, it may be politically impossible or at least very difficult to slow down, let alone reverse the protectionist trends that have become apparent in India and to a lesser extent in Bangladesh in recent years, to institute meaningful reforms in Sri Lanka, or even to avoid backtracking from the recent reforms in Pakistan.

Fertilizers

Judged according to their objectives i.e. low fertilizer prices for farmers and the substitution of local production for imports, the South Asian countries' fertilizer policies have been very successful. For example, farm urea prices in India declined by about 50 percent in real terms between the early 1980s and the mid 1990s. They have been well below both average production costs and import parity prices while domestic fertilizer production expanded to supply almost 90% of demand compared with about half in the early 1980s. Fertilizer prices for farmers were also kept very low in Pakistan, Bangladesh, Sri Lanka and Nepal, and in the first three domestic production rapidly substituted for imports.

Still, there are strong reasons for thinking that the "green revolution" in grain farming in South Asia could have occurred at much lower economic cost without the subsidized farm fertilizer prices, and that the forced import substitution in fertilizer production also involved high economic costs which were unnecessary because reliable supplies were available from imports. Recognizing this, all five countries have been taking reform initiatives of varying comprehensiveness.

These reforms can be grouped into effects in the rural economy, effects on domestic producers, and effects on the government's budget. For the rural economy, subsidized low prices for fertilizers lead to their overuse since the cost to farmers is lower than the opportunity costs of the fertilizers, where the opportunity cost is either the (marginal) cost of importing or producing them, plus distribution and marketing costs. Subsidies for non-urea fertilizers have now been abolished in all the South Asian countries except India. Urea subsidies were removed in Pakistan in 1996 and in Nepal in 1999, but there are still large direct subsidies of urea farm prices in India and Sri Lanka. In Bangladesh, there is no explicit subsidization of urea farm prices, but there are probably implicit subsidies in the sense that low prices for natural gas enable domestic producers to charge urea prices which are frequently below import parity prices.

As regards domestic fertilizer production, the pursuit of import substitution means that traditional fertilizer policies in South Asia have also involved high economic costs. The sources of these economic costs include:

- Direct government controls over imports
- Large input subsidies from low preferential feedstock prices
- Absence of price competition due to government mandated prices
- Management problems of public sector enterprises
- Cost-plus pricing
- Intrusive government regulation of firms

Finally, the traditional fertilizer policies in South Asia have involved high costs to national budgets. In India, where the full traditional structure is still in place, the fertilizer subsidy recognized in the 2000/01 central government budget was 4.2% of total central government revenue and 0.66% of GDP. This is without accounting for the substantial non-quantified subsidy from low feedstock prices to the domestic fertilizer industry.

Following liberalizing reforms in the other four principal South Asian countries, only Sri Lanka now pays an explicit budgetary subsidy (for urea), in 2000/01 equivalent to 0.21% of GDP. However, low natural gas prices to urea producers in Pakistan and Bangladesh amount to large subsidies. In Pakistan, these subsidies are entirely absorbed by the fertilizer manufacturers, as farm prices of urea are directly linked to world prices through decontrol of imports. In Bangladesh, an unknown share is passed on to farmers in the form of urea prices which are lower than import parity prices. Nepal has had no budgetary fertilizer subsidies since the fertilizer market was liberalized and farm fertilizer subsidies finally abolished in 1999.

Recommendations on fertilizer trade policies

The very substantial economic costs of the remaining subsidies and other interventions in fertilizer production and distribution are well recognized and broadly accepted in South Asia. The reform agenda with the largest economic payoff is in India, but backtracking from a major reform during the 1990s, and numerous false starts, also indicate that fertilizer policy reform there is extremely difficult politically, as it is in the other countries also. But what needs to be done is very clear. The essential reforms are:

- Abolishing or phasing out the explicit budgetary farm subsidies and the associated price and distribution controls in India and Sri Lanka
- Opening up fertilizer imports over low to moderate tariffs in India and Bangladesh so that domestic prices track world prices after allowing for transport and distribution costs
- Removing India's export ban and any remaining export controls in the other countries
- Removing feedstock and other producer subsidies in India, Pakistan and Bangladesh
- Abolishing or phasing out India's cost-plus pricing ("retention price") scheme in fertilizer manufacturing
- Managing whatever restructuring of fertilizer manufacturing and distribution follows from these reforms

Textiles, garments and the MFA phaseout

The quota system under the Multi-fiber Arrangement is being phased out by 2005 as part of the Agreement in Textiles and Clothing (ATC), and its dismantling is expected to increase the market access opportunities for T&C products from South Asia countries as well as pose serious challenges from increased competition in a quota-free regime. Exporters in South Asia will also have to continue to cope with tariff preferences for competitor countries associated with regional trade agreements such as NAFTA, or the various preferential trade arrangements of the EU.

However, South Asian countries are not evenly poised to reap the benefits from the larger T&C market or to cope with the new challenges. Clear beneficiaries of the quota system, which grew along with Sri Lanka into major exporting countries of ready made garments (RMG) in the 1990s, Bangladesh and Nepal suffer from major weaknesses that might stifle future growth of RMG exports. These are: considerable dependence on buyers' agents with buying houses providing orders for manufacturers' garmenting capacities, unreliable delivery dates and inconsistent quality, low labor productivity and machine utilization levels, limited market knowledge, and problems with ports and inland transport, especially in the case of Nepal. Post-MFA challenges in gaining greater market access in the expanding market for T&C products could be greater for these countries than for India, Pakistan and Sri Lanka, where T&C exports have been constrained by the MFA quota system.

Although the ATC provides the legal framework for the ten-year, four stage phasing of the MFA and the integration of T&C into the GATT/WTO framework by 2005, very few T&C categories (particularly in the largely labor-intensive apparel category) of interest to countries in South Asia were integrated in the now completed three stages. The limited integration of product categories in which the region's countries have comparative advantage suggests that virtually all of the liberalization of the politically sensitive high value- added textile and clothing items will come in the final stage.

Worldwide trends in T&C reveal that clothing and textile made-ups represent the growing segment of world T&C trade. While countries in South Asia have made impressive progress in exporting T&C products of good but not necessarily consistent quality, it has been largely in the low- to medium-range of goods, where price is the main determinant of success. The world competition for these goods is likely to be especially intense from the other low-wage countries which are increasingly being integrated in the global economy. It would be in their interests to diversify the product composition in terms of higher value-added textile and apparel products, where their labor cost advantage would be a significant advantage in the post-quota phase, provided they make the necessary adjustments in terms of reducing lead times through competitive sourcing of fabrics and enhancing transport and logistics efficiency.

Perhaps more than in any other part of the world, there are very substantial economic opportunities in the MFA phaseout for the South Asian countries. But, except in Sri Lanka, substantial segments of the domestic T&C markets of the South Asian countries are still heavily protected. This is a special problem in the textile sectors of India and Bangladesh, where many key products-especially synthetic fibers and yarns and textile fabrics-are protected against low cost imports through the use of specific duties and anti-dumping in India, and by very high ad-valorem tariffs plus quantitative import restrictions in Bangladesh. The high protection levels of domestic fabrics in India has in turn led to high protection of domestic garment production through the use of specific duties against low priced garment imports. Although Pakistan does not have QRs and its textile tariffs are much lower than textile tariffs in India and Bangladesh, they are quite escalated and provide fairly high effective protection rates to yarns and fabrics. For a number of reasons, this suggests that these countries are far from ready to take full advantage of the opportunities provided by the MFA phaseout.

Firstly, high protection takes the pressure off industries to improve their performance. Low cost, internationally competitive domestic T&C markets will provide a much better basis for exporting to a more competitive post-MFA world than a situation when all or some domestic segments of the T&C industries are protected. For example, there are many advantages for garment exporters when some or all of their fabric requirements are supplied by domestic textile firms e.g. shorter delivery times, closer contact with suppliers, avoiding the inevitably more complex formalities of international trade, especially at Customs. But exporters cannot afford to buy their inputs locally unless the firms that supply them are fully competitive with international suppliers.

Secondly, exports from a high cost protected domestic industry are much more vulnerable to anti-dumping in importing countries than exports from open competitive domestic markets where internal prices are in line with prices in export markets.

Thirdly, in addition to anti-dumping, after the MFA phaseout, T&C exporters in high protection countries are also likely to be more vulnerable than exporters in low protection countries to countervailing duty actions in importing countries that take aim at direct and indirect subsidies, especially excessive duty drawbacks or subsidies resulting from other schemes (such as the Indian advance licenses and duty exemption passbook (DEPB) scheme) which rebate or offset tariffs on directly or indirectly imported intermediate inputs.

Fourth,, bilateral and multilateral negotiations on world T&C trade are sure to continue after the MFA phaseout, including especially negotiations on regional preferences and the rules of origin associated with them, anti-dumping and subsidies rules, technical and health standards, and labor and environmental standards. The South Asian countries will have a much more credible role in these discussions and will be able to pursue their own negotiating interests more effectively if segments of their own domestic markets for textiles and clothing are not hermetically sealed or heavily protected against imports.

Fifth, low or zero protection and open domestic markets for T&C in South Asia would remove much if not all the motivation for both conventional and "official" (also known as "technical") smuggling between India and its neighbours, and would go much further towards establishing a South Asian common market for textiles and clothing than has happened under SAPTA or is likely to happen under the various bilateral trade agreements. This could be a major initiative to pursue under the new SAFTA agreement.

Sixth, open domestic markets would also greatly improve the benefit to South Asian garment exporters of preferential arrangements such as the EU's GSP, which provides preferences which are a function of the cumulative total value added from inputs produced in SAARC countries.

Finally, quite apart from the advantages for T&C exports following the MFA phaseout, South Asian consumers will benefit if protection is reduced or eliminated, as they have in Sri Lanka where there is free trade in textiles and a low 12 percent tariff on garments. In this regard, it is important to recall that in South Asia, although T&C exports are important, domestic sales are very large. The consumer benefits of reduced protection, lower prices, and a bigger range of choices between qualities and varieties in domestic markets are likely to be considerable, and in the large countries even bigger than the benefits to producers of greater success in export markets.

Recommendations on trade policies for textiles and clothing

For the reasons outlined above, the principal recommendation of this report for the trade policies for the T&C sectors of the South Asian countries, is to move to (or maintain if they are already in place, as is the case in Sri Lanka) low or zero tariff import regimes which are free of non-tariff barriers. This would require major reforms of current policies in India and Bangladesh, with India abolishing its specific tariffs, substantially reducing the general level of its *ad valorem* T&C tariffs, and avoiding the use of anti-dumping, and with Bangladesh abolishing or phasing out its textile QRs, and discontinuing the use of supplementary duties and VAT exemptions for domestic textile producers. Pakistan would substantially reduce its present prevailing 25% tariff on fabrics, and all four countries would need to cut their garment tariffs. All these changes would preferably form part of general "tops-down" tariff reform programs which would also simplify tariff structures and make them much more uniform.

In addition to the liberalization of trade policies, there are many other reforms of domestic policies and institutions which could improve the performance of the South Asian T&C industries and their capacity to face up to, and take advantage of the opportunities offered by the phasing out of the MFA e.g. by removing unnecessary regulatory controls, facilitating access to new technologies, simplifying domestic taxes and improving their administration, supporting specialized training for T&C workers, improving infrastructure services such as power, telecommunications, and transport, and in these and other ways generally creating better environments for both domestic and foreign firms to invest and operate in these sectors. Throughout the region, the MFA phaseout has spurred considerable activity in many of these areas which are complementary to trade policy reform.

Summing up

The trade policy issues examined above relate to important choices facing all of South Asia's five largest countries. The circumstances of each country, however, vary. Table 1 is meant to provide a compact comparative guide to the different national regimes, details of which will be found in the report's Volume I: An Overview of Trade Policies in South Asia.

The overview study of which this is a summary, is intended to provide current information on, and interpretations of traditional trade policies in South Asia. The premise of the study is that further trade liberalization would contribute to faster economic growth, and that faster economic growth is the principal long run instrument of poverty alleviation, provided that it is accompanied by adequate attention to basic social welfare institutions. Against this background, the study also makes a series of recommendations for reforms of current trade policies which are emphasized in this summary. In sum, this report argues that the region now needs to deepen and accelerate its reform in the trade policy area, to finish the process that was begun in the early 1990s by most, if not all, South Asian countries. These countries need to make the fundamental shift from protected, import-substituting to competitive export-oriented activities.

While generally not discussed in the report, it is recognized that trade policy liberalization on its own may not be sufficient, and that it needs to be accompanied by many complementary domestic reforms such as de-regulation and improvements in the functioning of labor markets, in governance, infrastructure facilities and services, and the general investment climate. Recognizing this and the frequent political difficulty of initiating and sustaining trade policy reforms, it is nevertheless hoped that the report will provide some starting points for applied, policy-relevant research and points of reference for useful discussion and debate

Table 1
Summary of Trade Regimes in South Asia

Policies	India March 04	Pakistan 2002/03	Bangladesh*** 2004/05	Sri Lanka Feb 04	Nepal August 03
Exchange Rate	Unified	Unified	Unified	Unified	Unified
Exchange Rate determination	Free float	Free float	Free float	Free float	Pegged to Indian Rupee
Payment convertibility					
Current account	Yes	Yes	Yes, some limits	Yes	Yes
Capital account	Yes, limited	No	No	No	No
Import restrictions (trade reasons)					
General import licensing	No	No	No, but some restrictions	No	No
Some QRs on imports	Yes	Yes	Yes	Yes, minor	Yes, minor
State import monopolies (excl POL)	Yes	No	No	No	No
Tariff structure May 03					
Top normal CD rate	30*	25	25.0	27.5	25
Other normal protective taxes	0	-	4.0	3.75	4.5
Top normal protection rate	30	25	29.0	31.25	29.5
Average CD rate	22.2	17.3	16.3	11.3	13.7
Average of other normal protective taxes	0	1.5	3.9	2.1	4.3
Average of other protective taxes	0	0	6.3	0	
Average CD+other protective taxes	22.2	18.8	26.5	13.4	18.0
% of products with total protection rates>normal maximum protection rate**	2.8	1.1	15.8	0.9	5.8
Number of normal CD slabs	7	4	4	6	5
Number of CD slabs>normal	17	10	None: uses para-tariffs & VAT exemption for extra protection	2	3
Range of CD slabs> normal	40-210%	40-250%		75 &100%	40, 80, 130%
% of ad valorem tariff lines >normal CD rate	2	0.1		0.2	5.2
% of tariff lines with specific duties	5.3	0.9		1.2	0.6
Uses anti-dumping	Yes	Yes	No	No	No
Percent tariff lines bound at WTO	72.4	36.8	13.2	26	*
Avg of bound tariff rates	50.6	61.4	188.3	50	*
Export policies					
Some export QRs	Yes	Yes	Yes	No	Yes
Some export taxes	Yes	Yes	No	Yes	Yes
Some direct export subsidies	Yes	No	Yes	No	No
Indirect export subsidies	Yes	Yes	Yes	Yes	Yes
Trade openness: trade-GDP ratio (%) 2000	19	33	33	77	44

CD=Customs duty (*) The "general maximum" CD rate is defined as a rate which includes at least 5% of total tariff lines, and above which there are no more than 10% of total tariff lines. The "general maximum " is 30% in India because of the large number of agricultural Customs duties clustered at this rate. The Indian general maximum CD rate for industrial tariffs is 20%.(**)Percent of tariff lines with total protection rates (inclusive of selective para-tariffs) in excess of "normal maximum" CD plus normal (generally used) para-tariffs . For more details on the data in this Table see the main report, Tables 3.1 and 3.2 of Chapter 3. (***) Tariff data on Bangladesh as of June, 2004. These figures reflect tariff changes announced in the FY05 budget on June 10, 2004, which indicated significant move towards reduction of protection: via reduction of the top rate to 25, move to three non-zero tariff slabs, and rationalization of supplementary duties.