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Trade Policies in South Asia: An Overview

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ACRONYMS AND ABBREVIATIONS

AD	Anti-Dumping
ADB	Asian Development Bank
AIC	Agricultural Inputs Corporation
AIT	Advance Income Taxes
AGOA	Africa Growth and Opportunity Act
AMS	Aggregate Measure of Support
AoA	Agreement on Agriculture
APEDA	Agriculture and Processed Foods Export
ASEAN	Association of South East Asian Nations
ATC	Agreement on Textile and Clothing
AV	Assessable Value
BADC	Bangladesh Agricultural Development
BCIC	Bangladesh Chemical Industries Corporation
BIS	Bureau of Indian Standards
BOP	Balance of Payment
CACM	Central American Common Market
CAM	Customs Modernization Program
CBERR	Caribbean Basin Economic Recovery Program
CBTPA	Caribbean Basin Trade Promotion Act
CCIE	Chief Controller of Imports and Exports
CCS	Cash Compensatory Support
CD	Customs Duty
CEC	Council for Economic Cooperation
CIF	Cost, Insurance and Freight
CMAI	Clothing Manufacturers' Association Fund
CMT	Cost of Manufacturing + Cost of Transport –
CPI	Consumer Price Index
CWE	Cooperative Wholesale Establishment
DAP	Diammonium Phosphate
DEPB	Duty Exemption Passbook
DGCI &	Directorate General of Commercial
DGFT	Directorate General of Foreign Trade
DRI	Department of Revenue Intelligence
DTRE	Duty and Tax Remission for Exports
EBA	Everything But-Arms
EC	European Commission
ELVIS	Electronic Visa Information System
EOUs	Export Only Units
EPCG	Export Promotion Capital Goods
EPO	Export Policy Order
EPZ	Export Processing Zone
ERP	Effective Rate of Protection
EU	European Union
FCI	Food Corporation of India
FDI	Foreign Direct Investment
FID	Fertilizer Import Department
FOB	Freight on Board
FTZ	Free Trade Zone
GATT	General Agreement on Tariff and Trade
GDP	Gross Domestic Product
GOI	Government of India
GSP	Generalized System of Preferences
HS	Harmonised Systems Code
HYO	Hank-Yarn Obligation
IDSC	Infrastructure Development Surcharge
IGEG	Inter-Governmental Expert Group
IMF	International Monetary Fund
IPO	Import Policy Order
IRRI	International Rice Research Institute
JIT	Just – in – Time
LCA	Letter of Credit Authorization
LDC	Less Developed Country
LLDC	Least Developed Countries
LPG	Liquified Petroleum Gas
MERC	Latin American Customs Union
MFA	Multifibre Arrangement
MFN	Most Favoured Nation
MINF	Ministry of Food, Agriculture and
MMTC	Metals and Minerals Trading
MOP	Muriate of Potass

NAFTA	North American Free Trade Area
NFC	National Fertilizer Corporation
NTB	Non-Tariff Barriers
NTC	National textile Corporation
OPT	Outward-Processing Trade
PASSC	Pakistan Agricultural Storage and Services
POL	Petroleum, Oil and Lubricants
POY	Polyester Partially Oriented Yarns
PSU	Public Sector Units
PTFY	Polyester Texturized Filament Yarn
QR	Quantitative Restrictions
REER	Real Effective Exchange Rate
RMG	Ready Made Garments
ROO	Rules-of-Origin
ROW	Rest of the World
SAARC	South Asian Association for Regional Cooperation
Sadd	Special Additional Duty
SAFTA	South Asian Free Trade Area
SAIL	Steel Authority of India
SAPT	South Asian Preferential Trade
SD	Non-supplementary Duty
SEZ	Special Economic Zone
SPS	Sanitary and Phyto-Sanitary
SRO	Statutory Regulatory Order
SSI	Small Scale Industry
STE	State Trading Enterprises
T & C	Textile and Clothing
TBT	Technical Barriers to Trade
TCB	Trading Corporation of Bangladesh
TPR	Trade Policy Review
TRIMs	Trade Related Investment Measures
TRQ	Tariff Rate Quotas
TUFS	Technological Upgradation Fund
TV	Tariff Values
UR	Uruguay Round
VAT	Value Added Tax
WTO	World Trade Organization

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Chapter 1: Introduction

Trade Regimes in South Asia

The countries of South Asia have a long history of inward-looking trade policies. Until the early 1990s, with the lone exception of Sri Lanka, few recognized that trade could serve as an engine of growth and poverty reduction. Long-standing trade policies, instead, (a) protected domestic industries in support of import-substitution strategies that were considered a sure way to rapid industrialization, growth and job creation; (b) reflected distrust of international markets and discriminated against exports through export controls and taxes, overvalued exchange rates, and the use of tariffs and other controls which impeded access to, and increased the costs of, the inputs needed for successful exporting; (c) discriminated against agricultural sectors where most poverty was located, through the use of parastatal monopolies and other restrictions over agricultural exports, and indirectly through much higher protection of manufacturing than of agriculture; (d) prevented or actively discouraged direct investment by foreign firms which – as sources of new technology and competition in other developing countries -- had contributed to rapid export growth. One consequence of these policies was that the South Asian countries missed the historic opportunity for rapid export and general economic growth that other developing countries-especially in East and South East Asia- seized during the 1960s, 1970s, and 1980s.

The trade policies followed in South Asia discriminated against intra-South Asian trade even more than against trade with the rest of the world. From the year after independence, in 1948, officially recorded intra-regional trade shrank from about 19% of total South Asian trade to less than 4% by 1974, picking up only slightly to 4.9% of total trade by 1998, mainly due to general trade liberalization on the part of the countries on India's periphery.

The potential for increased regional trade is not very great, compared to increased trade with the rest of the world (ROW), especially with the developed countries. While South Asian countries have comparative advantage in relation to ROW in similar, mostly labor- intensive products, the trade and economic benefits from trading these products among themselves are limited. This shows up in various statistics and indicators including:

- Trade intensity modified by geographical proximity
- Low correspondence between South Asian exports with revealed comparative advantage and South Asian import demand
- Low correspondence between the principal exports of the South Asian countries to ROW and their principal exports to other South Asian countries.

Even so, the potential for regional trade is much greater than the trade that is actually occurring. This is apparent from scattered studies of unrecorded/informal trade, the volume of which cannot be accurately quantified, but which could plausibly be as much as half of recorded trade or even more during some periods. The economic welfare effects of informal trade are complex. On the one hand, consumers benefit, as do firms which obtain smuggled intermediate inputs. Some informal trade is also reported to involve much lower transactions costs than the costs that would be incurred if the same goods were traded formally. But informal trade also involves substantial revenue losses, not only from evaded import duties but also from evaded indirect domestic taxes. It also creates uneven conditions of competition, and incentives for firms not directly involved in the informal trade to improve their competitive position by tax evasion and similar activities. This conduct, in turn, leads to increased enforcement efforts by tax and other government authorities, and associated costs for both enforcers and the general business community.

Trade liberalization in South Asia started with a series of sweeping reforms in Sri Lanka in 1977/78. There was some backtracking from these reforms during the 1980s, followed by a new second phase of trade liberalization between 1990 and 1996, but then some further backtracking when the ethnic conflict put heavy demands on revenue, part of it raised from import taxes. For the rest of South Asia, the 1980s and 1990s saw substantial reductions of tariffs and phasing out of QRs, along with liberalization of the exchange regimes. By about 1997, with some exceptions, Sri Lanka and Nepal had relatively open, low-to-moderate protection trade regimes, but despite substantial reforms, India, Bangladesh and Pakistan still remained among the most protected countries in the world. After 1997, however, Pakistan embarked on a sweeping trade liberalization program that it followed consistently for the next 6 years to emerge as a moderate- -protection country by general, developing-country standards. But between 1997 and about 2002, trade policy reform lost momentum and in some respects retrogressed in India and Bangladesh, a reaction, in part, to the financial crisis in East and South East Asia, the sharp devaluations of many of these currencies, and the consequent increased competitive pressures from these countries' exports. Reform resumed, however, with tariff reductions in Bangladesh's and India's 2002-03 budgets. Further small reductions were made in Bangladesh's 2003/04 budget, but they were partly offset by increases in other protective import taxes, and in general the resulting extent of trade policy liberalization was very modest. By contrast, India announced that the 2002-03 tariff cuts would be followed by future tariff reductions, and, with the important exception of agricultural tariffs, this program continued in the March 2003 budget, and again when sharp tariff reductions were announced on January 8, 2004. These changes drastically reduced India's average tariffs on manufactured and other non-agricultural goods by almost half compared to their level five years previously. However, agricultural tariffs were omitted from the latter stages of these reforms and they increased substantially after 2001. In early 2004 India's unweighted average agricultural tariff was higher than the unweighted average agricultural tariffs of all except a few of 105 developing countries, and was two and a half to six times the average levels of agricultural tariffs in other large developing countries, such as China, Brazil and Indonesia. Furthermore, even though India's non-agricultural tariffs have been drastically reduced, they still far exceed non-agricultural tariffs in the vast majority of other developing countries and in developed countries, in addition to which India has become a major user of other protective instruments, in particular specific duties, anti-dumping, state trading, tariff rate quotas, health and safety regulations, SPS and TBT.

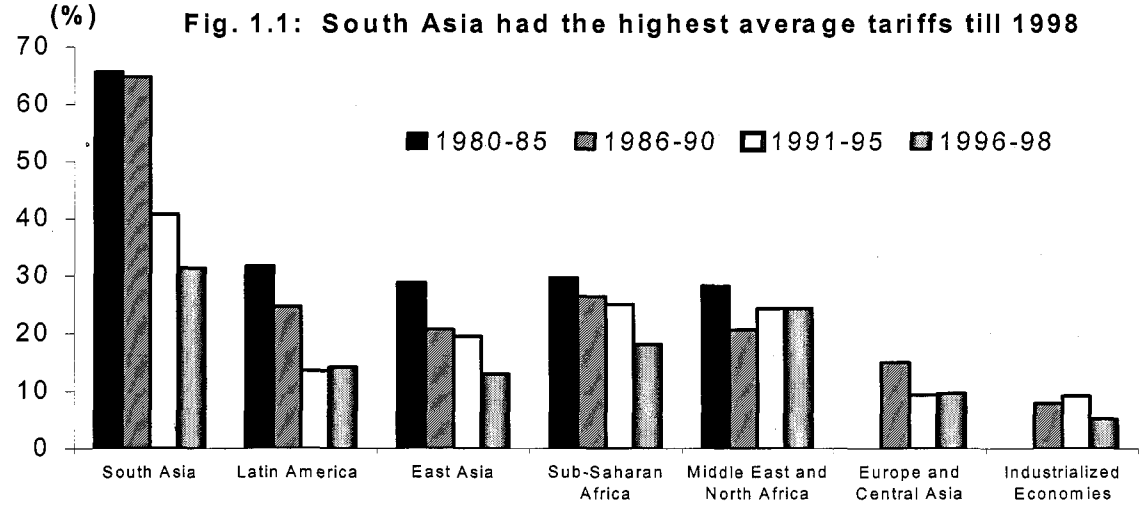


Fig. 1.1: South Asia had the highest average tariffs till 1998

Trade, Growth and Poverty Reduction in South Asia

Five decades of development experience has shown that being open to external trade and investment flows allows a developing country to grow faster economically than otherwise, and that faster economic growth is an effective and efficient means for alleviating poverty. For developing countries to achieve more rapid growth through greater integration with the world economy, a liberal and open global trading and financial system is essential. Except for Sri Lanka, which went for deep liberalization in the late 1970s and benefited from it, most of South Asia largely ignored these lessons. By the mid-1980s, however, some momentum in the direction of liberalization became noticeable in the region, with trade policy reforms being introduced during the late 1980s and early 1990s, in India, Pakistan, Bangladesh, and Nepal.

What were the impacts of these structural changes on the region's economic performance and on the conditions of the poor? Because of some variability in individual country performance, it is difficult to give a simple answer to this question. But some broad generalizations are possible if one sees the outcomes in the context of the global experience of developing countries that followed the route of greater trade openness.

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 experienced large increases in trade and significant reduction in tariff and non-tariff barriers. In contrast, the remaining two-thirds of the developing world, largely concentrated in Africa, that did not experience trade expansion due to a lack of sufficient outward orientation, performed poorly both in terms of growth and poverty reduction. For South Asia 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 (see Fig.1.3). The effect on reduction in poverty in India was dramatic, entirely in keeping with the Bhagwati hypothesis of the early 1960s that growth was the principal driver of poverty reduction. By the Government of India's (2000) estimates, poverty incidence fell from 51% in 1977-78 to 27% in 1999-2000. Bangladesh also experienced the sharpest reduction in poverty in the 1990s, from 45% in 1991 to 34% in 2000.

Fig. 1.2 South Asia's Poor (Headcount ratio 2000)

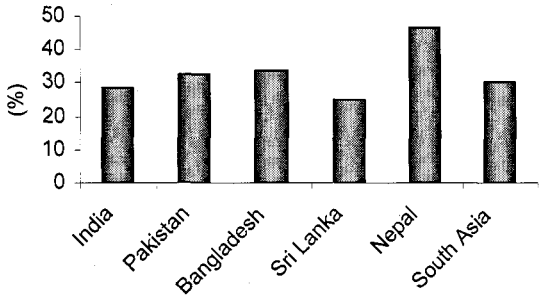
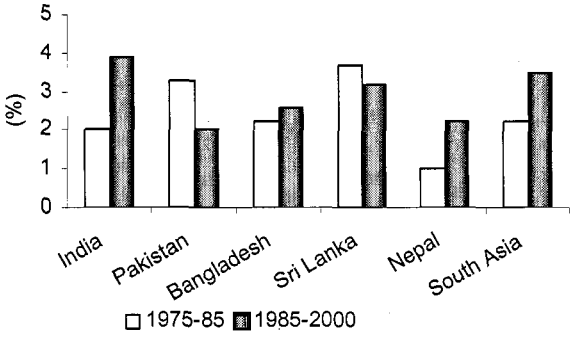


Fig. 1.3 South Asia's Growth Performance 1975-85 and 1985-2000 Per Capita Growth



The South Asian experience could be seen as further confirmation of the findings of recent global empirical research indicating the relationship between trade openness and growth. The linkage between greater trade openness and poverty reduction is not necessarily direct, but rather through the positive

impact of trade expansion on growth performance – a correlation that has been established in numerous empirical studies. Cross-country studies on the relationship between growth performance and poverty reduction conclude that there exists a close correspondence between growth of per capita income and growth of incomes of the poor, though all growth is not necessarily pro-poor. If trade openness has a favorable impact on growth and poverty reduction, then there seems to be a vast unfinished agenda of trade reforms to be undertaken by most of the countries in the South Asia region.

This Report

This study looks at some principal aspects of the current state of trade regimes in South Asia and points to the scope for further reform to achieve greater global economic integration. It covers the seven SAPTA countries, focusing mainly on India, Pakistan, Bangladesh, Sri Lanka and Nepal, with occasional references to Bhutan and Maldives.

At the outset, it must be noted that there are conceptual problems in generalizing about the extent to which whole economies are protected (for example high protection of import substitution industries implies high disprotection of export industries), and the various standard indicators of trade openness and of the extent to which economies are protected, are not always closely correlated. This ambiguity in generalizing about national levels of protection is especially marked in South Asia, where there has always been a great deal of redundant protection in the sense that (due to domestic internal competition and/or large scale smuggling) actual differences between domestic prices and world prices are frequently much less than would be implied by tariff levels or other formal protective instruments. Nevertheless, formal protective instruments are important, and in terms of them, despite past and continuing reforms, two of the large South Asian countries, India and Bangladesh, are still among the most protected and least open economies in the world. In 1996/97, Pakistan was also heavily protected and belonged in the same category, but following five years of consistent and sweeping trade policy liberalization, it now has a fairly open and relatively non-interventionist trade regime, with moderate protection by the standards of developing countries. In terms of the average level of its tariffs, Nepal's trade regime is about equivalent to Pakistan's, but its trade and trade policies are closely linked to and affected by developments in India. Except for some major agricultural crops, Sri Lanka has a much more open trade regime than these four, and mainly through its bilateral free trade agreement with India and to a limited extent through SAPTA, it also has important trade and trade policy connections with the rest of the subcontinent. Some salient features of the current trade policy situation in each of these countries are briefly outlined below.

Current trade policies: some salient features

In India, trade liberalization that started during 1991/92 continued for about five years during the 1990s, but lost momentum in some key respects between 1997 and 2001. Under outside pressures which originated in the Uruguay Round, the large number of QRs that India retained to protect consumer good producers were phased out during this period. On the other hand, many industrial import tariffs rose, anti-dumping became a major activity, specific duties were imposed to protect the textile and garment industry, local content (TRIMS) arrangements were used in the auto industry, and towards the end of the period especially, tariffs protecting major agricultural products and agro-industries were substantially increased. Substantial tariff reform resumed, however, with the reduction of the general maximum customs duty from 35 percent to 30 percent in the 2002/03 budget, to 25 percent in the 2003/04 budget, and to 20 percent on January 8, 2004, when another protective import tax (the Special Additional Duty) was also abolished. But agriculture was excluded from this new liberalizing initiative: state trading import monopolies are being maintained over the major foodgrains, and agricultural tariffs have been going up even as the average level of industrial tariffs has been declining. India's unweighted average agricultural tariff in February 2004 (including tariffs on processed foods) exceeded the latest available

estimates of average agricultural tariffs in all but three (Turkey, South Korea and Morocco) of 124 developed and developing countries.

In Pakistan, trade liberalization which started in the 1980s continued slowly but without serious interruptions until 1996/97. A new, comprehensive trade liberalization program commenced in that year and continued until 2002/03, when the general maximum Customs duty was reduced to 25%. Actual protection rates are a bit higher then Customs duties, however, owing to differences in the incidence of an income withholding tax which is applied to imports and domestic transactions. No major changes to tariffs were made in the 2003/04 budget, and there are no officially announced plans for further reductions in industrial tariffs. On the other hand, the government has largely completed an ambitious and politically sensitive program of comprehensive liberalization of the trade and other policies that affect its agricultural sector. This contrasts with India, Bangladesh and Sri Lanka, where there are strong protectionist elements in agricultural policies. One factor influencing trade policy liberalization in Pakistan is the recognition of the large volumes of illegal imports via Afghanistan and from India that high protection has encouraged.

Bangladesh has a very large export-oriented garment industry established in the 1980s, which has grown rapidly during the 1990s to the present. However, many of the manufacturing industries supplying the domestic market are still heavily protected: tariffs (including the effects of protective import taxes on top of Customs duties) of 50 to over 100 percent are common. As in India, trade liberalization slowed down in Bangladesh from about 1995. Customs duties were reduced, but these reductions were offset by the use of a variety of other protective import taxes. By 2000/01 these para-tariffs accounted for more than one-third of Customs collections from protective import taxes. In addition, Bangladesh has retained a number of QRs, some ostensibly for trade reasons, the purpose of which is to protect large local industries, notably textile fabric producers. The 2002/03 budget reduced the basic maximum customs duty and abolished one of the para-tariffs, and there was a further reduction in the basic maximum Customs duty in the 2003/04 budget, but increases in the other para-tariffs more than offset this reduction. In early 2004, as measured by its average unweighted protective import taxes, Bangladesh was the most protected of the South Asian economies, with especially high tariffs and other taxes in agriculture. However, the extent to which these measures actually enable local firms to increase their prices is uncertain, owing to the large volumes of illegal imports, especially from India. The illegal imports include conventional smuggling across the border that by-passes Customs posts, but a larger volume is generally considered to be "official" smuggling which comes through both the port and land Customs posts, involving under-invoicing and other misdeclarations, despite the operations of pre-shipment inspection organizations.

Sri Lanka's trade and its industrial sector are dominated by its export-oriented garment industry and its textile sector. Despite the addition of a surcharge to Customs duties, industrial tariffs are low, and in 1997 all textile tariffs were abolished and since then the textile industry has been operating under free-trade conditions, both in supplying garment exporters and the domestic market. However, there is significant protection of some manufacturing industries, and also considerable intervention and protection of some major agricultural import substitution crops, especially rice, potatoes, onions and chilies. Sri Lanka's early trade liberalization and the appreciation of its currency in relation to the Indian Rupee led to a large and growing trade deficit with India, and in the hope of correcting this deficit, Sri Lanka entered into a free trade agreement with India which became operative in March 2000. Although Sri Lankan exports to India have increased quite rapidly since then, up to 2002/03 they were still very small, and the bilateral trade deficit with India had increased substantially. In the future, if Sri Lanka's internal conflict is resolved and its economy takes off with rapid, export-led growth, the strength of the rice and other agricultural lobbies suggests that trade policies may go in the direction of the East Asian countries such as Korea, with an agricultural sector shrinking in relative terms but benefiting from very high protection.

Nepal has generally low, but some moderate and a few high industrial tariffs. Agricultural trade is quite open with low tariffs. Under its trade treaty with India, Nepal gives generally rather small preferences to imports from India, but most of its exports to India are duty free, although subject to quite restrictive rules of origin and other barriers. Of the very substantial illegal trade with India, some of which bypasses Customs posts, a large portion is under-invoiced, misclassified, or otherwise un-or under-recorded at Customs. Because Nepal's tariffs are generally much lower than India's, India is highly sensitive to Nepal's trade policies and periodically imposes special tariffs or other restrictions. This happened in early 2002 when India imposed tariff rate quotas on Nepalese exports to India of vegetable ghee (hydrogenated palm oil) and copper wire and rods and imposed anti-dumping duties on acrylic yarns. These measures caused considerable disruption in Nepal. In 2002, in order to finance the conflict with the Maoist guerilla movement, the Nepalese government added a "security tax" to its Customs tariffs but not to domestic transactions, thereby increasing tariff protection for local industries. At least while the conflict continues, it seems unlikely that Nepal will reduce tariffs or otherwise liberalize its trade policies.

Bhutan About 80 percent of Bhutan's merchandise trade is with India, approximately three quarters of its imports and 95 percent of its exports. In addition, its hydro-electricity exports, which are the principal driving force in its economy, are entirely to India. India's dominance in Bhutan's trade is a natural outcome of its location, but is reinforced by a free trade agreement under which Bhutan's exports are exempt from Indian tariffs, and Bhutanese imports from India are exempt from Bhutan's import licensing and from tariffs. For a tiny economy, some of Bhutan's tariffs are rather high, and protection is further increased by a sales tax which is applied to imports but not to the production of local import substitution firms. *A priori,* these arrangements appear to be economically inefficient in some ways, by diverting imports from third countries to higher cost suppliers in India, and by providing excessive protection to local import substitution production. On the other hand, the FTA may benefit some Bhutanese exporters by giving them duty free access to protected markets in India.

Maldives[1] Foreign exchange earnings in the Maldives are predominantly from tourism and fish exports. Customs duties on imports provide about two-thirds of government tax revenue, as there are no other indirect taxes. For a very small economy, tariffs are quite high, averaging about 21 percent, and even though there is no local production of most imported goods, they have the potential to shelter pockets of high cost local production and to distort resource allocation away from economically more efficient activities, especially export related activities. In the past a number of imported products were subject to QRs, but most of these were removed quite recently in 1998. However, as of December 2002, import quotas, most of which were allocated to a parastatal (the State Trading Organization), were still being used to regulate imports of rice, sugar and wheat flour. About a fifth of Maldives trade (mainly imports) is with South Asia, about 13 percent with Sri Lanka and 8 percent with India: trade with Pakistan, Bangladesh, Nepal and Bhutan is zero or negligible.

Trends in Real Effective Exchange Rates

As background for later discussion, Figs I.1-I.12 illustrate trends in the real effective exchange rates (REERs) since 1980 of each of the South Asian countries, both the general REER indices for total trade (the CPI-based versions) and the bilateral real exchange rate of each country's currency with the Indian Rupee (also CPI-based). Trade weighted REER indices are not available for Bhutan and Maldives: Figs 1.13 and 1.14 just show their bilateral CPI-based indices with the Indian Rupee. Since, except for Maldives, India is the dominant regional trading partner for the other South Asian countries, real exchange rate trends with the Indian Rupee are important influences on the volume and direction of intra-regional trade, both formal and informal.

[1] Most of the information in this section is from the WTO's December 2002 , TPR report on the Maldives.

The most important general development for the South Asian region during this period was the continuing and eventually very large devaluation (around 150% in real terms) of the Indian Rupee, starting in 1985 and ending in 1992. From 1992 to late 1997, the nominal exchange rate was managed so as to approximately just offset, but not exceed, inflation in India relative to inflation rates in its trading partners. From early 1998, the REER began to slowly appreciate, reflecting a strengthening balance of payments driven by growing manufactured exports, the rapid expansion of services (especially software) exports, and capital inflow. However, in late 2003 the appreciation since 1998 was only about 13 percent, and the total real devaluation since the mid-1980s was still well over 100 percent. The sharp devaluation of July 1991, which was part of the IMF-World Bank supported policy package to deal with India's balance of payments crisis, can be seen in retrospect to have been an acceleration of a trend already underway for about six years. Because the Indian Rupee devaluation up to 1992 was much faster and larger than REER changes in Pakistan, Bangladesh and Sri Lanka, the Indian Rupee became much cheaper relative to their currencies in real terms. This has helped spur Indian recorded and unrecorded informal regional exports, especially to Bangladesh and Sri Lanka, while making it more difficult for the peripheral countries to export to India. Bangladesh and Sri Lanka have been concerned about the resulting large bilateral trade deficits with India, but the Indian devaluation is best interpreted as a return to a more normal and economically efficient situation, following many years of extreme exchange rate overvaluation in India, during which India's exports to the rest of the world as well as to the other South Asian countries were taxed and compressed.

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 their growth, and at the same time sharpened import competition. With the notable exception of Pakistan, the increase in import competition was an important factor in the slowing of the general momentum of import liberalization in the region, and its reversal in some respects in India and Bangladesh between 1997 and 2002.

Some of the linkages of the exchange rate to trade policy developments in each of the countries are briefly summarized below.

India. The early Rupee devaluation from the mid-1980s (about 85% in real terms between end-1985 and end-1990) which preceded the 1991/92 crisis was associated to some extent with the slow, cautious liberalization of intermediate and capital goods imports that occurred during this period, but principally with growing budget deficits that discouraged remittances and capital inflows. The subsequent crisis- induced devaluation of 1991/92 was more than sufficient to limit imports following the removal of most QRs on intermediate and capital goods and the abandonment of industrial licensing, key elements of the 1991/92 economic liberalization program. Consequently, no further devaluation was required after 1992 to support the pre-announced tariff reduction program that continued until about 1996/97. The devalued exchange rate also supported rapid export expansion, especially of manufactured exports, but also of some agricultural and agro-industrial products.

Before 1996/97, there is evidence of considerable tariff redundancy across a wide range of manufactured products, including consumer goods which continued to be protected by import licensing, in practice, an import ban for most. However, around that time the tariff reductions began to bite for some producers of intermediate and capital goods no longer protected by QRs, and pressures from these groups were reflected in tariff increases, increased anti-dumping activity, local content schemes, and the application of increasingly rigorous health, safety and technical regulations to imports. On the other hand, in about 1997 it became apparent that India would no longer be able to permanently continue its general import licensing system, which still effectively banned the import of nearly all consumer goods and agricultural commodities. Following a delaying action by India at the WTO (see later discussion), these

QRs were removed in stages and finally abolished in April 2001, but tariffs and other protective measures have turned out to be more than sufficient to prevent a major surge in consumer-good imports.

Combined with slower but continued growth of manufactured exports, the rapid expansion of software exports, and increased capital inflow, since 1998 it has been possible to allow the real exchange rate to appreciate slowly but steadily while maintaining a satisfactory current account balance. Although India's tradable economy is still very heavily protected, it is also considerably more diversified, flexible and competitive than it was 12 or 13 years ago, before its liberalizing reforms took hold. Consequently, no significant exchange rate adjustments were needed to support the new tariff reduction program for industrial products that started with the 2002/03 budget and continued until January 2004.

Pakistan. 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 (Fig 1.5). The total devaluation between about 1985 and 1992 was more than two-thirds in real terms, and as in India, it was in part a consequence of, and a support for, trade liberalization measures introduced during the period. The devaluation after 1998 also helped insulate Pakistani producers to some extent from declining world prices for a number of major commodities which followed the 1997 Asian financial crisis, and supported a tariff reduction program which started in 1996/97. During the 1980s, until about 1987, the rate of devaluation in Pakistan somewhat exceeded the devaluation rate in India, so that the bilateral Pakistan/India Rupee rate was also steadily devalued. But after 1987 the Indian devaluation rate was much faster than Pakistan's, so that Pakistan's bilateral real exchange rate with India strengthened by about 30 percent between 1987 and 1993 (Fig I.6). The bilateral real Pakistan Rupee/Indian Rupee rate remained at about this appreciated level until the end of the 1990s, when it declined rather steeply, reflecting faster nominal devaluation by Pakistan. As noted later, the appreciated level of the real bilateral rate with India, which was maintained until about 1998, was associated with a fairly fast growth of officially recorded imports from India, albeit from an extremely small base owing to the very restrictive trading relationship between the two countries. This trend did not continue during and after 1999, but this had more to do with periods of worsened diplomatic relations than with the sharp real depreciation of the bilateral Pakistan/India rupee exchange rate. In 2003, total officially recorded trade between India and Pakistan constituted only 0.22 percent of India's total trade, and only about 1 percent of Pakistan's total trade.

Bangladesh. Compared with India and Pakistan, Bangladesh's REER has been remarkably stable for over 20 years (Fig 1.7). Except for a period in the mid 1980s during which the REER appreciated rapidly for three years but was then devalued sharply during 1985, the rate has moved within a fairly narrow band of about 10% around trends of slow devaluation from 1980 up to about 1996, modest appreciation from 1997 to 1999, followed by steady but slow devaluation during the following four years. The strength of the Taka during this period is in part due to the rapid growth of ready-made garment exports from $US 116 million in 1985 to $US 4.8 billion in 2000, and increasing remittances, both through formal channels and unrecorded, from Bangladesh workers outside the country. Together, these increases more than offset the decline in aid inflows relative to GDP, and were sufficient to balance whatever increases in imports resulted from the trade-liberalization measures implemented during the 1980s and 1990s. However, one consequence of the relatively stable Taka alongside the massive devaluation of the Indian Rupee between 1985 and 1992, was that the bilateral real Taka/Rupee rate appreciated by about 30 percent during the same period (Fig I.5). During the 1990s, this appreciating trend of the real Taka/Rupee rate continued at a slower pace until, in 1999, the total real appreciation of the Taka relative to its value in 1983 was more than 50 percent. Combined with Bangladesh's gradual removal of QRs and tariff reductions over the same period, this led to a rapid growth of imports from India, which during the 1990s became Bangladesh's largest single supplier, accounting for between 15-18% of its total recorded imports. In addition, studies of informal trade suggest a similar, large increase in unrecorded imports from India. If this is correct, India could be supplying as much as 25% to 30% of

Bangladesh's total imports. By contrast, Bangladesh's officially recorded exports to India have remained at very low levels and have barely changed over more than 10 years: in 2003 they were only about $US 62 million, compared with Indian officially recorded exports to Bangladesh of about $US 1.2 billion. These developments have made the trading relationship with India a key concern in Bangladesh, with some groups using the import competition from India and the large bilateral trade deficit to argue against both further general trade liberalization and preferential or free trade arrangements with India, while others argue for general trade liberalization combined with reform of the Customs service, so as to divert illegal imports into legal channels.

Sri Lanka. As in Bangladesh, REER movements in Sri Lanka since 1980 are also very different from the trends in India and Pakistan (Fig1.9). Compared to the latter two, and especially to India, the Sri Lankan REER has moved within a relatively restricted range and currently the index is only about 10-15 percent below its level in 1980. The first phase of Sri Lanka's trade liberalization started much earlier than in the other South Asian countries, in 1977. The early reforms were supported by a sharp nominal devaluation, but these were soon overtaken by inflation that resulted from large increases in government spending, especially on the massive Mahaweli irrigation project which aimed to make Sri Lanka self-sufficient in rice production[2]. Consequently, during the 1980s until about 1986 the REER appreciated by roughly 20 to 25 percent. This trend was reversed between 1986 and 1989, after which the REER stayed at about the same level until it appreciated again from late 1995 onwards. One important reason for the relative stability of the Sri Lankan Rupee over this long period, has been the rapid and sustained expansion of manufactured exports, mainly garments, which now account for about 60% of total exports, compared with less than 10% before the 1977 reforms. As in Bangladesh, the stability of the Sri Lankan Rupee involved a large appreciation in the real bilateral exchange rate with India, in total by about 60 percent between 1981 and 1998 (Fig 1.10). Together with Sri Lanka's generally open import regime, this in turn has led to rapid growth of imports from India, and a large bilateral trade deficit. In 2003, imports from India exceeded those from any other individual country, and accounted for about 14 percent of Sri Lanka's total imports. The desire to reduce the bilateral trade deficit with India through better access to the Indian market played an important part for Sri Lanka in negotiating the free trade agreement with India, which became operative in March 2000[3]. This was perceived as having relatively low trade-diversion costs for Sri Lanka owing to its generally low tariffs, 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 (see later discussion).

Nepal. The Nepalese Rupee is set at a fixed rate with the Indian Rupee, and since inflation rates in Nepal do not differ greatly from inflation rates in India, Nepal's REER index (Fig.1.8) has broadly followed the Indian Rupee index, the principal difference being that the Indian Rupee component, which has a very high trade weight, has not greatly changed. Hence the increase (devaluation) in Nepal's REER index from the mid-1980s to 1992 was much less pronounced than the equivalent increase in the Indian REER index. Even so, the real devaluation that did occur during these years with respect to Nepal's other trading partners was substantial and, as in India, made tariff reduction and other trade liberalization measures carried out in this period relatively painless. From the mid-1990s until early 2002 the Nepalese REER strengthened somewhat, probably reflecting increasing tourism receipts, which are also allowed for in the REER estimate itself, but in 2002 there was a sharp reversal of this trend. Because of apparently higher inflation in Nepal than in India, Nepal's real bilateral exchange rate with the Indian Rupee also strengthened consistently from the mid-1980s until 1999/2000, when the trend reversed (Fig.1.12). If the differences between the Nepalese and Indian price indices which give these results are credible indicators of relative inflation rates in the two countries, the attractiveness of Nepalese exports to India should have declined up to about 1999/2000, whereas importing from India into Nepal should have become more

[2] For a discussion of exchange rate policy during Sri Lanka's reforms, see Athukorola and Rajipatirana (2000), Chapter 4.
[3] For a summary of the India-Sri Lanka Free Trade Agreement and further references see Pursell and Pitigala (2001, August).

profitable, with these trends partially reversed since. The bilateral real exchange rates with the other South Asian currencies have not been estimated, but Nepal's REER devaluation from the mid 1980s suggests that a substantial real devaluation of the Nepalese Rupee with these currencies would have occurred, which would have boosted Nepalese exports had there been adequate transport links.

Bhutan. Bhutan's currency, the Ngultrum, is fixed at par with the Indian Rupee, and Indian Rupees freely circulate and can be used for transactions in Bhutan. There are no estimates of trade-weighted nominal or real effective exchange rates for the Ngultrum, but such a series would be in any case be dominated by the REER with the Indian Rupee. This is entirely a function of the difference between inflation in Bhutan and inflation in India. As measured by the CPI indices, it seems (Fig 1.13) that between 1980 and 1999, because of persistently higher inflation in Bhutan than in India, there was a small but consistent real appreciation of the Ngultrum, the cumulative result of which was that by 1999 the bilateral REER index had appreciated by almost 30 percent. There was a slight reversal of this trend after 1999, but at the end of 2002 the cumulative appreciation was still substantial. Aid inflows and electricity exports to India which started in the mid-1980s, both of which are large in relation to the size of Bhutan's economy, suggest that the currency appreciation which the series indicates, has been real and sustainable, and is not merely the result of systematic errors in relative inflation rates as measured by trends in the Bhutanese and Indian CPI indices. However, because of the tie to the Indian Rupee, like the Rupee the Ngultrum would have been very substantially devalued from the mid-1980s until about 1992, with respect to both the currencies of the other South Asian countries and countries outside the region. For the same reason, if they were calculated, REER trends with other currencies would approximate trends in the equivalent real India Rupee rates with those currencies.

Maldives. For many years the Maldives currency, the Rufiyaa, has been pegged to the US dollar, but the rate has been changed (usually devalued) periodically to take account of the changing strength of the dollar, and generally higher inflation in the Maldives than in the US and other developed countries. Between 1980 and 2003, the nominal Rufiyaa/US dollar rate was devalued by about 70 percent. There are no long term trade- weighted REER estimates for Maldives, but estimates for 1995-2000[4] indicate substantial real appreciation, probably reflecting the strength of the US dollar during those years. As was the case in Pakistan, Bangladesh and Sri Lanka, the Maldives bilateral real exchange rate with India (Fig 1.14)[5] appreciated very substantially during the late 1980s and early 1990s, by about 50 percent between 1998 and 1993. After 1993 it has remained at this appreciated level, except for some slow real devaluation starting in about 2000. As noted previously, the Maldives's principal export earnings are from tourism and fish exports, and the principal role of the tariff system is to generate government revenue. Hence the interplay between exchange rates, tariff levels and protection for local industries has not been as important in the Maldives as it has been in the other South Asian countries.

[4] WTO (2002), Maldives TPR report Table 1.3. The WTO report does not indicate how the REER numbers have been calculated, and in particular whether weights have been given to tourism receipts.

[5] Maldives CPI index numbers for 1983-87 are missing and the bilateral REER index could not be estimated for those years

Fig 1.4
India Real Effective Exchange Rate Index 1980-2003
(Annual averages: Increase=devalutaion)

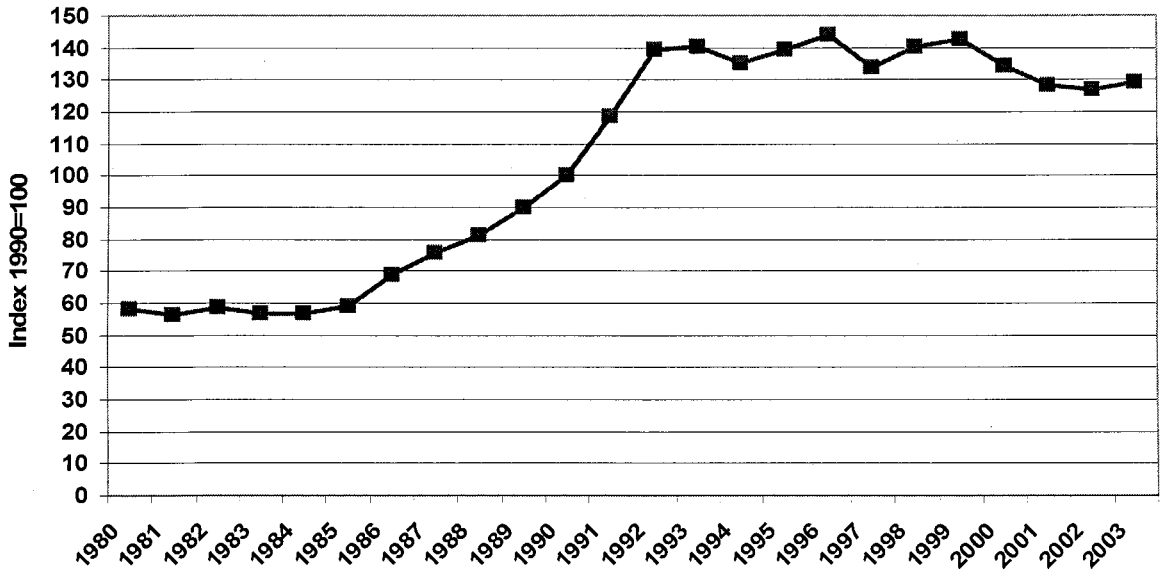


Fig 1.5
Pakistan Exchange Rate Indices 1980-2003
(Annual averages: increase=devaluation)

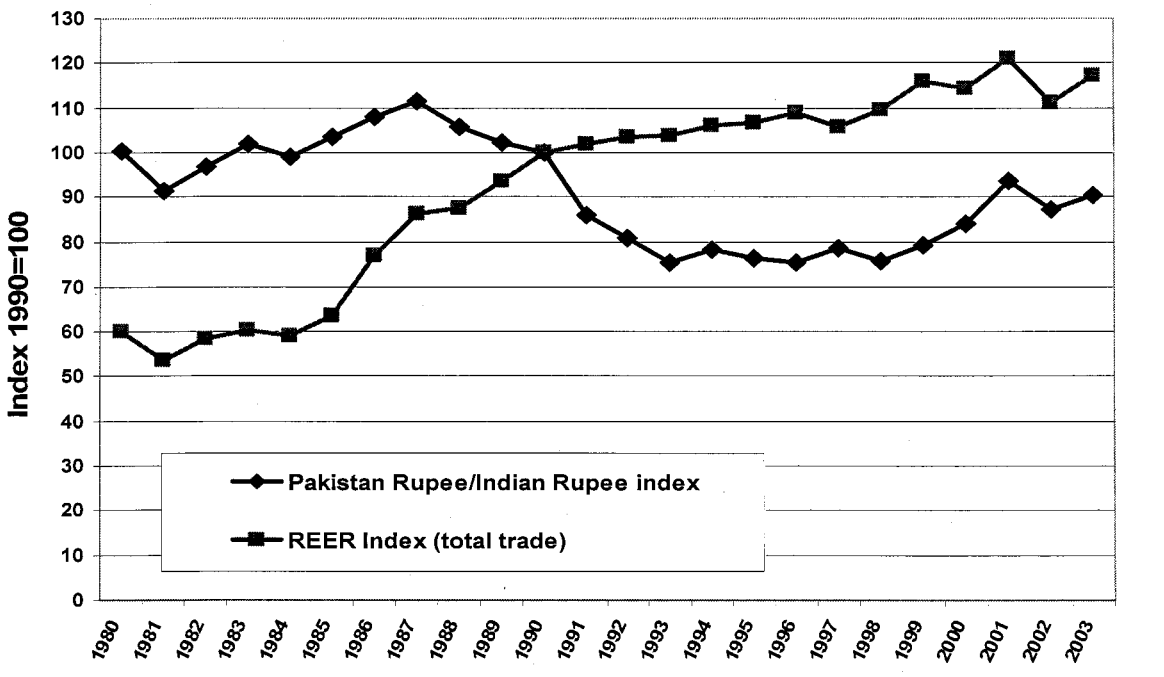


Fig 1.6
Bangladesh Real Exchange Rate Indices 1980-2003
(Annual averages: increase=devaluation)

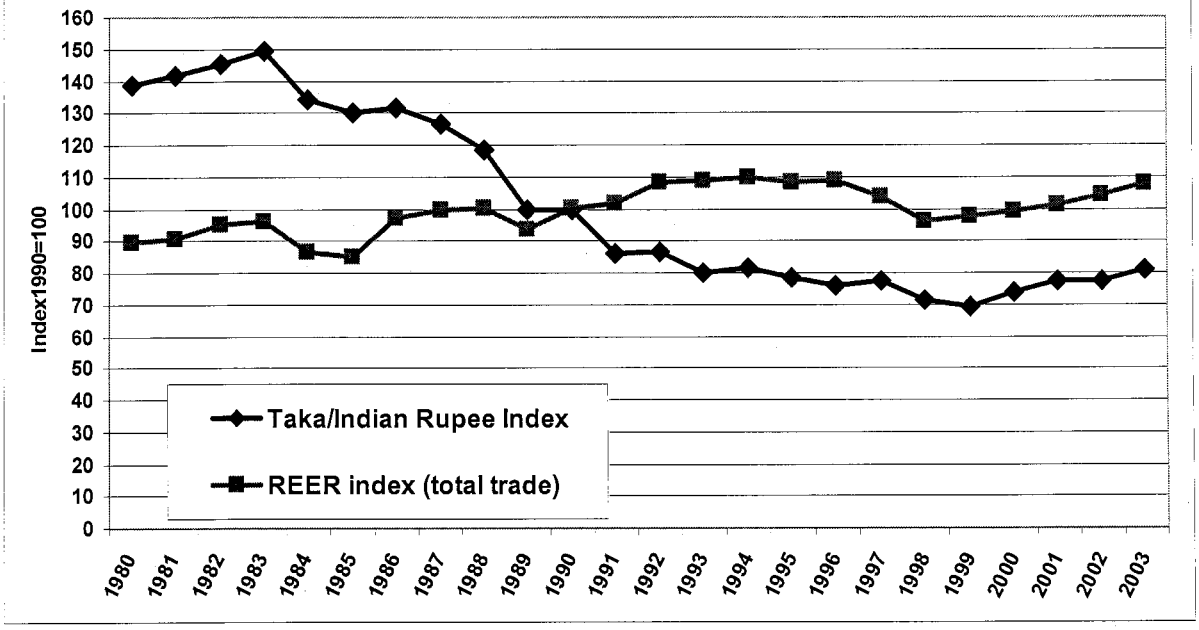


Fig 1.7
Sri Lanka Exchange Rate Indices 1980-2003
(Annual averages: Increase=Devaluat ion)

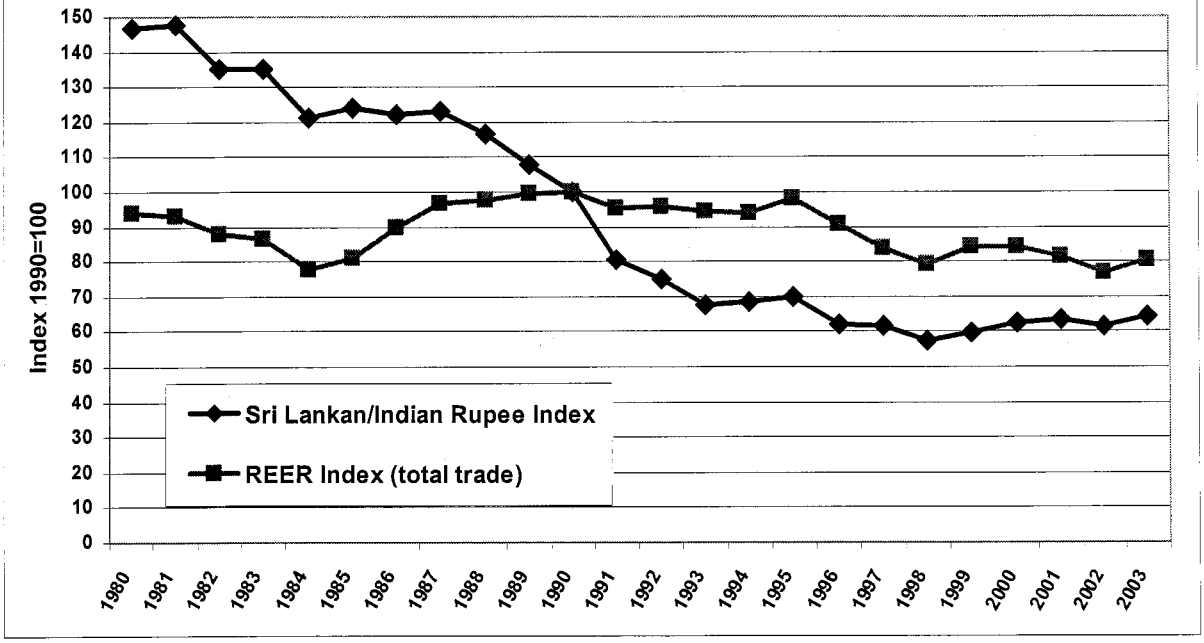


Fig 1.8
Nepal Exchange Rate Indices 1980-2003
(Annual averages: Increase=devaluation)

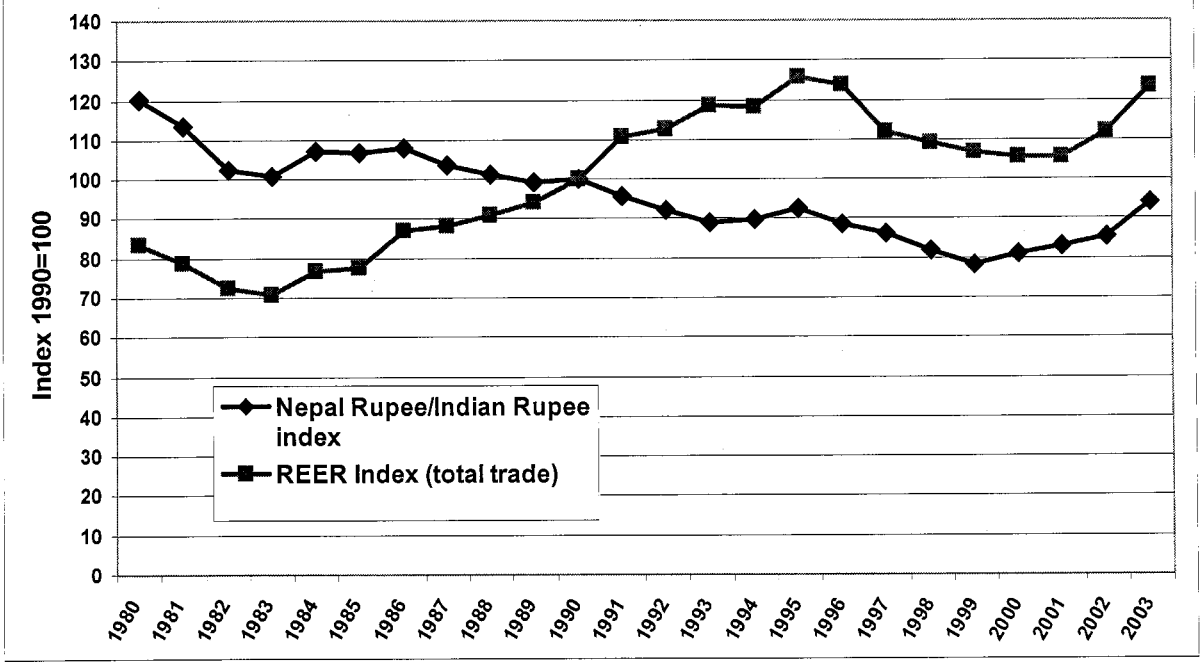
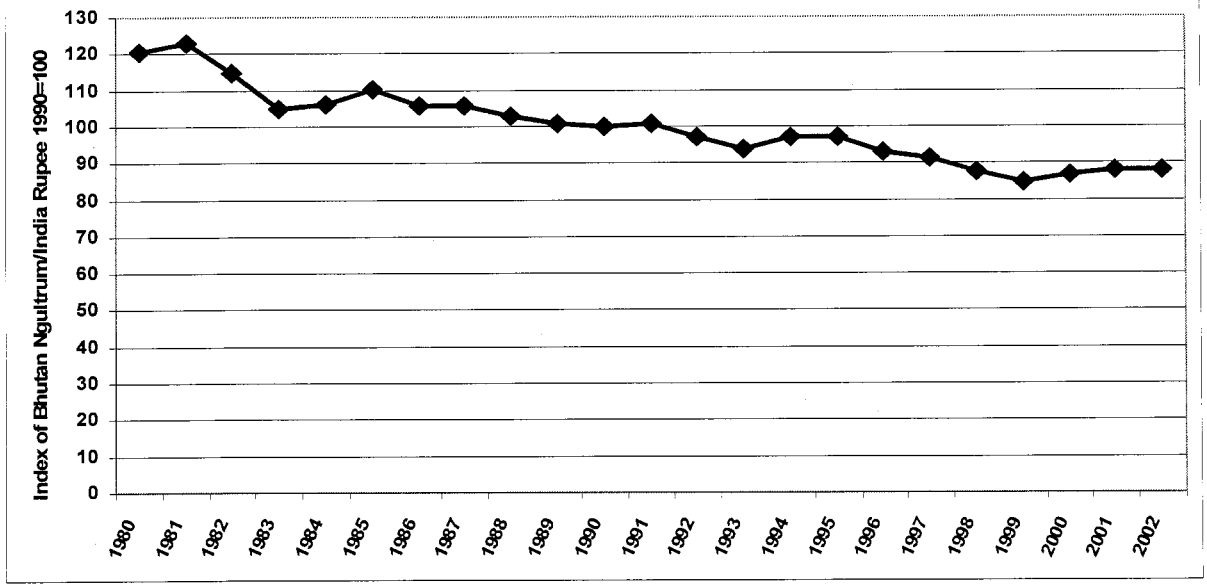


Fig 1.9
Bhutan-India Real Exchange Rate Index 1980-2002
(Annual averages: increase=devaluation)



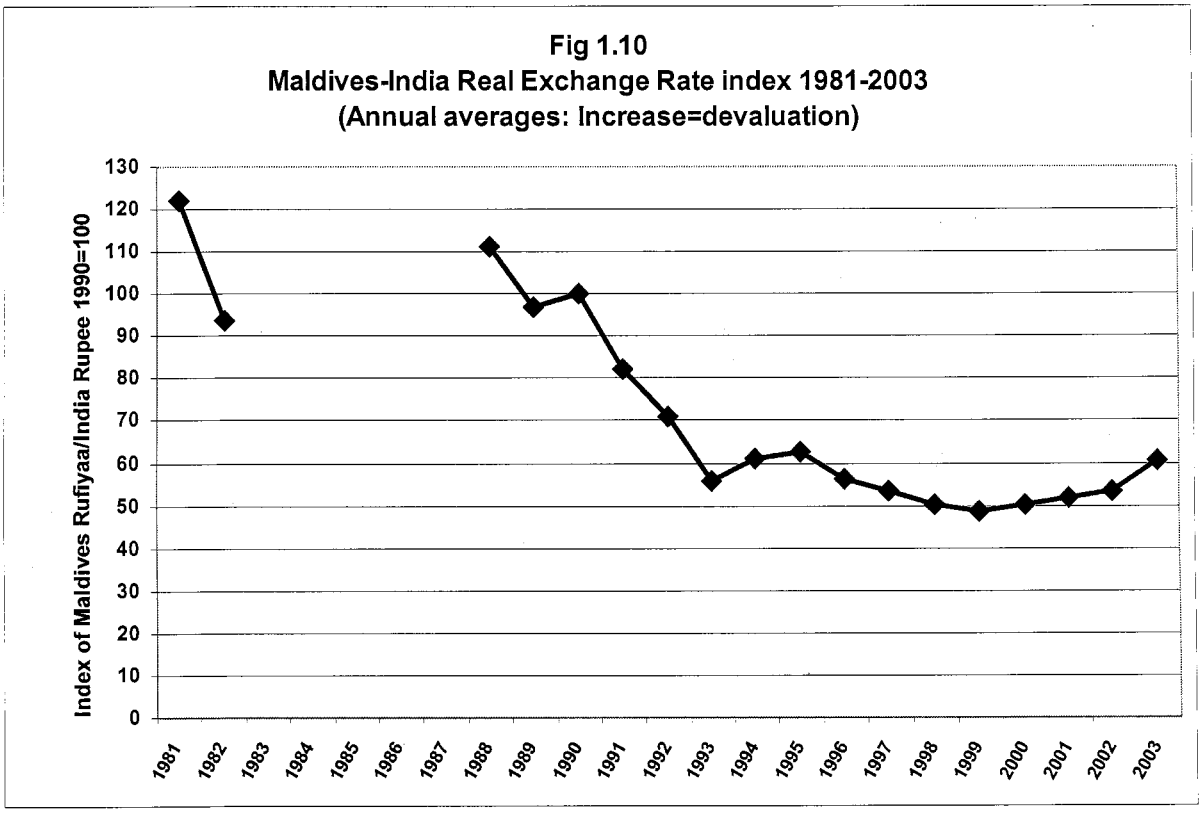


Fig 1.10
Maldives-India Real Exchange Rate index 1981-2003
(Annual averages: Increase=devaluation)
Index of Maldives Rufiyaa/India Rupee 1990=100
130
120
110
100
90
80
70
60
50
40
30
20
10
0
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003

Chapter 2: Non-Tariff Import Barriers

INTRODUCTION

During their earlier periods of government-controlled, planned development the South Asian countries used QRs of all kinds as the predominant means of controlling imports and protecting local industries. QRs of various kinds were also used, though less frequently, to control exports: these are discussed in Chapter 4, which deals with export policies. The QRs applied to imports included *de jure* and *de facto* import bans (in India for many years import licensing amounted to a *de facto* ban on the import of nearly all consumer goods), import licensing, import quotas (infrequently), government or government-mandated import monopolies, and a variety of other non-tariff barriers. As pointed out in Chapter 1, trade liberalization in these countries followed different timetables and moved at different speeds. Some indication of the rate of removal of traditional protective QRs (i.e. import licensing and import quotas) is given in Fig II.1, illustrating trends in QR protection in India, Pakistan, Bangladesh and Sri Lanka from the 1980s until 1998. Before looking at what has happened in the individual countries since 1998, the following general points are worth noting:

- By 1998 the QR regimes of these four countries were much less comprehensive than they had been in the 1980s
- With some exceptions, Nepal was never such an active user of non-tariff import controls as the other major South Asian countries, nor was Bhutan. However, because of their location, dependence on trade with India, and difficult access to the rest of the world, to a large extent, producers in Nepal and Bhutan were and remain indirectly protected through whatever protection policies are followed in India.
- Serious QR removal in the region started first in Sri Lanka, in 1977.
- Substantial QR liberalization got under way in Pakistan and Bangladesh during the mid-1980s, but only after 1991 in India.
- There was some slow relaxation of QRs in India during the second half of the 1980s, but discretionary QRs remained much more important than in the other South Asian countries until the removal of import licensing from most capital and intermediate goods began in 1991. In particular, all consumer goods (including agricultural products) remained subject to import licensing, which amounted for most to a *de facto* import ban. The phasing out of these QRs began in 1998, and the last set was finally lifted in April 2001. However, as of February 2004, the import of most major agricultural commodities in India were still controlled by government-owned or government-authorized import monopolies[1], and a wide range of other formally GATT-consistent NTBs were in place.
- With a few exceptions,[3] the other South Asian countries no longer maintain state trading arrangements for agricultural commodities. In addition, Pakistan, Sri Lanka, Nepal (and also Bhutan and Maldives) are not active users of other non-tariff techniques for restricting imports, in contrast to India and to a lesser extent Bangladesh, where NTBs still have a major role.

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[1] These agricultural import and export monopolies (e.g. the Food Corporation of India) were previously called "canalizing agencies". For consistency with the WTO Agreement on Agriculture, they are now known as "State Trading Enterprises" (STEs). Whereas in principle all QRs applied to products covered under the Agreement on Agriculture are GATT-illegal, STEs are permitted provided their operations meet certain conditions.

[2] Notably, a wheat import monopoly in Sri Lanka.

[3] Notably, a wheat import monopoly in Sri Lanka.

INDIA

As noted in Chapter 1, India's 1991/92 reforms removed most but not all QRs from manufactured intermediate goods and machinery and equipment. But nearly all consumer goods (manufactured or otherwise) remained subject to import licensing, in practice an import ban, and the import of nearly all agricultural products was subject to import licensing or controlled by parastatal import monopolies ("canalizing agencies"). It has been estimated that in May 1995, about two-thirds of tradable GDP was still protected by some kind of non-tariff import restriction: 84 percent of agriculture, 36 percent of manufacturing, and 40 percent of mining and quarrying[4]. During the second half of the 1990s, these restrictions were gradually removed in large measure in response to international pressures. The first of these pressures came out of the Uruguay Round negotiations on textiles and clothing, and the second from a dispute brought against India at the WTO under the balance-of-payments clause of the GATT (Article XVIII (B).

Before 1991 all imports of textiles and garments were in practice banned, except for some intermediate textiles used in the manufacture of exported textiles and garments and imported using special arrangements for exporters. The 1991/92 reforms did not change this policy. In December 1994, however, in separate treaties with the EU and the USA, in part as a quid pro quo for the ATC agreement to phase out the MFA quotas, and in part in exchange for increases in its MFA quotas in these markets, India agreed to a comprehensive liberalization of these policies. In early 1995 the process started by freeing (i.e., removing QRs) imports of wool tops, synthetic fibers, textile yarns and some selected industrial fabrics. At the same time selected textile fabrics (most woolen and synthetic fabrics but few cotton fabrics), selected textile products ("made-ups"), and a fairly long list of apparel items,[5] were made eligible to be imported with the use of a new import license issued to exporters (see below). It was also agreed that these products would be freed from import licensing altogether at specified future dates (in 1998, 2000 or 2002), and tariff rates were agreed which were to decline to levels of between 20 and 40 percent by the year 2000. These important reforms, though negotiated with the USA and EU, were multilateral; under the WTO MFN principle, they applied and continue to apply to all countries exporting to India.

In negotiating these agreements, India was careful to leave itself considerable discretion in their implementation. Most importantly, it reserved the right to revert to its 1990 import policies (an import ban and tariffs of 110 percent or more) if the liberalization process envisaged by the WTO agreement on textiles and clothing does not materialize in full or is delayed. Secondly, it reaffirmed its right to restrict textile imports under the GATT balance of payments provision. Thirdly, it was agreed that the negotiated maximum tariffs could be varied by levying specific duties. Finally, most cotton fabrics, which account for the bulk of Indian fabric production, and about half the apparel tariff lines, were omitted from the treaties altogether and were subject to continuing QRs (in practice an import ban) with no commitment to remove them in the future. Despite all this, when considered in the light of India's hermetic textile and apparel import policies of the previous 40 or so years, the US/EU agreements constituted a major step towards a more liberal trade regime.

The second international influence on India's QR regime also came out of the Uruguay Round. Since 1955 India had used the GATT balance of payments provision (Article XVIII (B) to justify its routine use of QRs. This right was reasserted in its Uruguay Round submissions and its continuing import bans and other quantitative import restrictions were formally justified on this ground. Moreover, India also claimed exemption from the "minimum access" requirements of the Uruguay Round agricultural

[4] Pursell, Garry (1996). *Indian Trade Policies since the 1991/92 Reforms* (World Bank, mimeo)

[5] The lists of Indian products to be liberalised under the US and the EU treaties are largely complementary . Between them, about 125 of 233 six digit HSC tariff lines in the apparel Chapters of the Indian tariff book were covered.

agreement, which might have obliged it to import limited quantities of otherwise restricted agricultural products. But signing the Round agreement and becoming a WTO member also involved acceding to an undertaking to discontinue the use of QRs under Article XVIII (B), unless they are justified by much more stringent standards than had been applied in the past.

In the post-Uruguay Round GATT, there is a strong presumption that countries should manage balance of payments difficulties by the use of fiscal and monetary policies and exchange rate adjustments. If for some reason these actions are not sufficient, tariff surcharges should be used to limit imports, rather than import restrictions. Whatever measures are used are supposed to be temporary, price-based, administered in a transparent manner, and most importantly, applied only to control the *general level* of imports. This last provision was and remains crucial, because it makes it patently absurd to pretend that QRs are protecting the balance of payments when they are selectively applied only to some products. Soon after the Round agreements became effective, during 1995 a number of countries' import restrictions (including Sri Lanka's - see below) were questioned in the WTO balance of payments committee[6], and in December 1995 India's theretofore unrestrained use of QRs was strongly challenged by the US, the EU and other developed countries[7]. In these discussions, the position that the QRs were justified by India's balance of payments situation was particularly difficult to maintain, given that in the years following the July 1991 devaluation, there were a strong current account, substantial capital inflows, and large foreign exchange reserves which for a while caused the Reserve Bank of India to intervene to prevent the Rupee from appreciating. Thereafter, India fought a five-year rearguard action to preserve its QRs against the developed-country challenge, and removed the last 715 of the 2714 tariff lines subject to BOP-justified QRs in the April 1, 2001 Export-Import policy announcement.

Since April 2001, therefore, India has no longer been using the GATT BOP clause to justify conventional import licensing which protects domestic industries. But understandably, against the background of approximately 40 years of *de facto* autarchy, when these controls were finally lifted, there was great deal of apprehension about how well domestic producers of manufactured consumer goods and agricultural products would be able to compete with imports. In response to these apprehensions, in May 2001 a "War Room" was established in the Ministry of Commerce, and a list of 300 "sensitive" consumer goods published, imports of which have since been regularly monitored with a view to taking prompt action to preempt or minimize disruption of local production by competing imports. Products are periodically removed from or added to the list: in February 2004[8] it consisted of 240 HS products, including meats, dairy products, nuts, fruits, coffee, tea, spices, cereals, edible oils, silk products, cotton, stones, ceramic products, motor cars, toys, pens, pencils and others. Domestic production of many of these products is now protected by special measures, including high tariffs and also by the use of various non-tariff techniques. The way for this was prepared during the negotiations on the Article XVIII (B) case at the WTO, when, in addition to the 2714 BOP-justified tariff lines, India listed 600 tariff lines on which it said import controls of some kind were justified on other grounds, in particular under GATT Articles XX (b) (protection of human, animal or plant life or health) and Article XXI (security and defense), or which it said were justified under the GATT STE (state trading enterprise) rules that that allow government-authorized import or export monopolies. Consequently, in India, imports are subject to nearly all the non-tariff restrictions which are formally compatible with GATT rules. NTBs in force currently or during the recent past, include the following:

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[6] In October 1995, Brazil's use of the balance of payments argument for the use of QRs was also severely criticized in the WTO Committee on Balance of Payments Restrictions. In November 1995 the Committee recommended against Sri Lanka's quantitative restrictions.

[7] Australia, New Zealand, Canada Switzerland and eventually Japan

[8] Imports of the sensitive products are regularly published on the DGFT (Ministry of Commerce) website at <http://dgff.delhi.nic.in>

Government mandated import monopolies or State Trading Enterprises (STEs). In South Asia , India is the principal remaining user of STEs ("canalizing agencies") 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. Beginning in 2003, STE import monopolies have also been used to administer import quotas for vegetable fats (vanaspati) and edible oils from Nepal[9]. Imports of urea and the most important refined petroleum products are also controlled by STEs[10]. By contrast, 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 producers of powdered milk, maize, crude sunflower and safflower oils, and refined rape, colza and mustard oil. These were introduced quite recently to permit small quotas of these products to be imported over moderate tariffs, while applying high tariffs which are generally 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 (e.g. 60 percent for powdered milk and 100 percent for maize). A secondary function of the TRQs is to subsidize parastatal firms, since they are the only entities eligible to apply for them, and they therefore benefit from the economic rents[11].

Technical standards and regulations. It has been reported (see Box 2.1) that new rules introduced in 2000 and being administered by the Bureau of Indian Standards (BIS), are being systematically used to restrict imports of products which are periodically moved on and off the list e.g. imports of 33 types of steel products were restricted in this way for almost three years, until they were removed from the BIS list in October 2003, following substantial increases in world steel prices[12]. The use of technical regulations is dealt with by the WTO agreement on Technical Barriers to Trade (the TBT agreement), which provides that technical regulations should not be used as disguised restrictions on trade. India has long been concerned about the effects of other countries' technical standards and regulations on its exports, but now appears to be using these techniques to restrict imports[13].

Sanitary and phytosanitary (SPS) rules. As noted above, following the final phase out of the BOP-justified QRs on April 1, 2001, India continued import licensing of 600 items which it said was justified by other GATT articles, in particular on the grounds that restrictions are needed to ensure "human, animal or plant life or health". A number of these continuing restrictions were challenged at the WTO by the EU, and in March 2003 some of the restrictions (on spices) were dropped. However, around

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[9] Nepal's tariffs on edible oils-especially palm oil- are much lower than India's very high (specific) tariffs protecting this industry. Consequently, as with a number of other products with high protection in India, exports of processed crude oils from Nepal to India benefiting from the duty exemption under the India-Nepal Treaty of Trade, have always been an irritant in India-Nepal trade relations. This came to a head in 2002 and 2003: the problem was solved by India setting tariff rate quotas and allocating the quotas to the State Trading Corporation (for vanaspati) and the Central Warehousing Corporation (for edible oils).. The normal out-of-quota specific tariffs for these products are prohibitive for Nepal, given its inland location.

[10] Gasoline, diesel, aviation fuel and kerosene are "canalized" by public sector oil companies. Kerosene was free of import licensing for some years but was recanalized in November 2003. According to Goyal (*Big's Weekly Index of Changes,* Vol XX, No 36) this followed complaints about import competition from the public sector oil companies and a major private sector refinery (Reliance Petroleum). Crude oil imports used by the domestic refineries are not canalized.

[11] The import quotas are allocated by a committee headed by a Ministry of Commerce (DGFT) official. See Goyal (*Biggs Weekly...)* Vol XX, Nos 7 & 8, 14-27 May, 2003.

[12] Goyal (*Biggs Weekly...)* Vol XX No 32, 5-11 November, 2003.

[13] There are reports that imports of other products not on the BIS list are also being restricted by technical regulations e.g. in December 2003, the import of measuring tapes containing inches and feet was banned by the Customs, using the Standards of Weights and Measures Act , 1976 as justification. It was reported that this was done to protect the sole Indian producer of measuring tapes (Goyal, *Biggs Weekly...,* Vol XX, No 36, 3-9 December, 2003)

Box 2.1 Technical barriers to trade in India

Indian standards are managed by the Bureau of Indian Standards (BIS), which is also the inquiry point for standards required under the WTO TBT agreement[1]. India has signed the TBT agreement, and in principle its activities in the standards area conform to the agreement's basic provisions that technical regulations and standards "do not create unnecessary obstacles to international trade" and that "they are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail or a disguised restriction on international trade"[2]. However, in November 2000, apparently as the result of a recommendation of the "War Room" set up in the Ministry of Commerce to monitor and combat excessive imports that were feared would follow the final phase out of QRs, a list of 133 products and product groups for which standards had previously either been voluntary or which had been compulsory but not enforced against imports, were made compulsory. Since then various groups of products have been dropped from and added to the list: in early 2004 it consisted of about 118 items. Although at first sight this is not a very extensive list, the items are very broadly defined e.g. items such as "structural steel (ordinary quality)" or "hot rolled carbon steel sheet and strip" correspond to a large number of HS tariff lines, and to a substantial volume of domestic production and potential imports. To be sold in India, these products are required to be certified as meeting Indian quality standards and must obtain an Indian standard mark. The 159 products and product groups that are or have been on the list include food ingredients, powdered milk and other milk products, cements, steel tubes, steel sheets and other steel products, X-ray equipment, gas cylinders, dry batteries, electrical equipment, and household electrical appliances.

According to BIS, the certification scheme operates in "in an impartial, non-discriminatory and transparent manner." In accordance with this principle, it is required that the products of both domestic and foreign suppliers be tested for quality and meet the same standards. For Indian suppliers the transaction costs in getting their products certified should in principle be quite low in view of BIS's presence in most of India (with 17 branch offices, 5 regional offices, 8 testing laboratories in different cities, and the use of independent laboratories). The costs are also quite low: application fee Rs 1000 (about $20), annual license fee Rs 1000, license renewal Rs 500, inspection charges Rs 2000 per day. However, at least for steel products, which were included on the list for about three years until they were dropped in October 2003, the way this was implemented for foreign exporters and Indian importers was such that, according to Indian traders in the steel business, the new regulation effectively shut out all "off-the-shelf" foreign supplies of steel from the Indian market. The reason for this is easy to see from the list of conditions (applicable to all products, not just steel) a foreign supplier is required to meet:

(1) It has to set up a liaison or branch office in India; operating through an Indian agent is not sufficient[3].

(2) A BIS technical team has to visit the foreign supplier's factory to inspect and certify that the production process meets the Indian standards. The cost of the visit and the test is paid by the foreign firm.

(3) There is an annual "marking fee" of $US $2000 plus 1% of the invoice price of products shipped to India plus an annual license fee of Rs 1000.

(4) The initial license is good for one year and can be renewed, subject though to "follow-up periodic inspections," the costs of which are also borne by the exporting firm.

As an alternative to this an Indian importer can apply for certification of imported products in which case he is in principle treated as equivalent to an Indian manufacturer. But this includes:

(1)An obligation to set up a "fully equipped laboratory for testing."

(2) The right of BIS to "impose any conditions" which may include (a) pre-certification of components/raw materials and (b) a visit to the original product manufacturer's premises at the expense of the importer.

The key deterrents to imports in this system are the obligation on the foreign manufacturer to establish an Indian office, the required visits to the foreign factories by BIS inspectors, and in the case of Indian importers, the requirement to establish their own testing laboratories and the broad discretion of the BIS inspectors as to pre-certification of components and visits to the foreign factories. Apart from the cost of all these procedures, there is obviously considerable potential for delay when foreign visits and the establishment of Indian branch or liaison offices are involved. It would appear to be almost impossible for foreign trading firms which buy from different sources around the world to meet the conditions and to supply India with products included on this list. As regards steel, according to Goyal[4]:

"Steel industry with 33 standards is due for a good dose of protection. Practically the whole range of steels ranging from hot rolled to cold rolled to alloy and stainless steel is covered....There is no harmonised system code on the items, which means that the customs has full power to classify arbitrarily and the importer will never know where he stands before the crucial customs clearance event"

Consequently, in the case of steel, while the restrictions were in place, it is probable that only large, long-term suppliers with sufficient volume to justify the transaction and other costs of meeting the BIS conditions would have been able to export steel and the other products on the BIS list to India. A similar result has been reported for dairy products, where: "It is almost impossible to get past the BIS standard restriction. The costs in the inspection process of the foreign dairy, subsequent certification, and the discriminatory marking fee will daunt imports." [5] The system also confers a great deal of "license Raj" type discretion on BIS and Customs officials and appears to be violating the spirit if not the letter of the TBT agreement. One obvious way to change this outcome would be action by BIS to accept international standards or standards in the exporting countries, through mutual recognition agreements with them.

1. For more on this see the May 2002 WTO TPR report on India and the Bureau of Standards website <www.bis.org.in>
2. Quoted from the preamble of the Agreement on Technical Barriers to Trade. WTO, 1994. *Results of the Uruguay Round of the Multilateral Trade Negotiations. The Legal Texts.*
3. It is provided that the establishment of an Indian office may not be required if there is an agreement between the Indian government and the government of the exporter's country guaranteeing the liabilities of the exporter under the BIS legislation
4. Goyal. *Easy Reference Customs Tariff 2002-2003*,p. P/38.
5. Goyal. *Biggs Weekly Index..., Vol XX No 25, 17-23 September, 2003*

the time of the general QR phase-out, old laws on plant quarantine, sanitary permits, food adulteration etc were reactivated and applied to imports: now imports of nearly all livestock, agricultural, and food products require some kind of phytosanitary or sanitary certificate issued under the general supervision of the Ministry of Agriculture. These are discussed at greater length in the chapter on agriculture (see Volume II, Chapter 1). As in other countries, these regulations reflect legitimate national concerns, but they have considerable potential to be used to restrict imports. It has been reported that this in fact has been happening in India, with the rules not being rigorously applied to domestic production, but involving a substantial harassment factor at Customs which heavily disadvantages imports.

Other health and safety regulations. Apart from food products, there are two other major groups of import restrictions justified on the grounds of health and safety, pharmaceuticals and pharmaceutical intermediates, and second hand goods. Import licensing for pharmaceuticals was introduced in April 2003, and has onerous requirements under which foreign manufacturers must register and subject their premises to inspection, along the lines of rules applied by the BIS[14]. Especially in the case of pharmaceuticals, health and safety are legitimate concerns, but domestic industries also have a motive to influence the ways the rules are applied in practice to keep out competing imports. In some cases protection of local producers clearly seems to be the dominant motive for the restrictions. This is especially apparent as regards the import bans and restrictions on second hand products, including second hand consumer goods, used and waste intermediate materials, and second hand machinery and equipment. The restrictions on consumer good imports include a longstanding ban on the import of used clothing, restrictions on the import of second hand household machinery such as air conditioners and refrigerators, and restrictions on the import of second hand cars. It is significant that imports of used clothing are banned in India but are allowed in the rest of South Asia, and that second hand cars are a major import in Bangladesh and Sri Lanka, where there is no domestic car production, but are respectively banned and restricted in India and Pakistan, where there are heavily protected domestic auto industries. The case for banning or restricting the import of scrap and other used raw materials and second hand machinery on health and safety grounds is even more dubious, given the very large volumes of domestic scrap, second grade materials and old machines that are traded in India. In the case of second hand machinery and equipment imports, however, reforms introduced in the 2003/04 budget to benefit exporters seem to have the potential to gradually undermine these restrictions (see Chapter 4 on export policies).

Local content (Trade Related Investment Measures or TRIMS) schemes. These act as NTBs, and were widely used for many years in India, 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 Uruguay Round TRIMS agreement. After this, India discontinued a number of its pre-existing TRIMS arrangements, but introduced a major new local content program in its auto industry. Following objections from other WTO members and protracted consultations at the WTO, India finally dropped its auto local content program in 2002[15], and at present does not appear to be operating any others. However, in WTO negotiations, together with Brazil, Pakistan and other developing countries, it has consistently pressed for changes that would exempt or partially exempt developing countries from the TRIMS rules, presumably signaling its interest in having at least the right to use these measures in the future.

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[14] For imported drugs, this system replaced the previous system under which both domestically produced and imported drugs were licensed at the manufacturing, packing and labeling, or distribution stages. At the same time the system was widened to include all drugs of therapeutic value, and not just designated classes of drugs subject to special controls. According to Goyal, by this measure the Indian government was "...raising prices and reducing availability just to retaliate against developed countries and pay them in their own coin". See Goyal, *Biggs Weekly Index...*, Vol XX No 4, 22-28 April 2003.

[15] A WTO panel found against India (see WTO documents WT/DS146/R and WT/DS175/R, 21 Dec 2001) in a dispute initiated by the US and the EU. India appealed the panel finding to the WTO Tribunal, but subsequently withdrew the appeal.

Limiting the ports and inland Customs posts at which imports can be cleared. A technique which India has systematically used to make the import of "sensitive" products more difficult, is the designation of specified ports and land Customs posts at which these products can be cleared. For example, initially, from May 2001, the 300 "sensitive items" could only be imported through 11 Customs posts out of a total of 215[16]. Only one out of 51 inland container depots at which containers could normally be cleared, could be used for these products, in addition to which none of the 145 import entry points along the land borders with Bangladesh, Bhutan, Nepal, Myanmar, China and Pakistan could be used. The list of authorized Customs clearance points for these products was later increased (by February 2004 to about 70), but the ability to move products on and off the "sensitive list" and on and off the list of places through which they can be imported, still operates in many ways as a substitute for the old "license Raj" negative lists, and is a particularly effective non-tariff technique for regulating imports from the inland areas of neighboring countries. For example, in February 2004, clothing accessories could only be imported through five specified ports and two inland container depots[17]. The same technique is also being used to regulate imports in other contexts e.g. under the India-Sri Lanka FTA, imports from Sri Lanka of clothing and tea (both "sensitive" products in the FTA, with duty free imports subject to Indian quotas) can only be made, respectively, through four and two specified ports. The official reasons usually given for restricting Customs clearance points in these ways, is that Customs posts other than those specified are considered to be less reliable (e.g. in controlling mis-declarations and under-invoicing) and also do not possess the required capability to monitor and provide timely information on the volume and nature of imports of these "sensitive" items (e.g. information that would be needed to keep track of how tariff- exempt tea and garment imports from Sri Lanka are developing in relation to the bilateral FTA quotas).

Restricting imports of domestically produced intermediate inputs used by exporters. India operates a comprehensive set of export mechanisms, the object of which is to free inputs which are used in exports, from import duties and domestic taxes. One of the most widely used facilities used by exporters (see Chapter 4 for more detail) are "advance licenses", under which inputs needed for exports can be imported duty free in advance of production, on the basis of confirmed L/Cs for the exports. As in other countries, this facility allows countries which export the intermediate inputs to sell duty free to Indian exporters, even if their access to the Indian domestic market is restricted by tariffs or NTBs. However, in response to domestic lobbies, India has periodically banned the import of some intermediate products used by exporters unless they pay normal import duties. For example, the import of natural rubber for use by exporters under advance (duty free) import licenses was banned for a period of four and a half years, between March 1999 and July 2003. This import ban reflected the lobbying power of the heavily protected rubber growers, mainly in Kerala, against the tire, footwear and other exporters, and was finally only removed following protracted legal proceedings finishing in the Indian Supreme Court[18]. For a while Indian pharmaceutical exporters were also subject to a similar restriction, under which the issue of duty free advance licenses for drug intermediates were subject to the controls on drug imports for use in the domestic market, that were introduced in April 2003[19]. These measures are perfectly compatible with the GATT – countries are not obliged to exempt imports from normal import duties – but (insofar as exporters still operate even while not using some or all of the normal export facilities), they do provide additional protection for the domestic producers of the intermediate inputs.

[16] This and the following information on the "sensitive list" is from Goyal, *Biggs Weekly Index,* Vol XVIII, Nos 5 & 6, 10 May 2001.

[17] Ministry of Finance, Dept of Revenue notification No 150, 14.10. 2003.

[18] Goyal, *Biggs Weekly Index, Vol XX,* Nos 15, 31 and 38

PAKISTAN

Pakistan used import licensing and other non-tariff barriers to imports widely during its early import substitution period, but they were never as pervasive or as multi-layered as in India. They began to be removed during the 1980s, with progress continuing steadily into the 1990s so that by 1998 (Fig 2.1) the proportion of product lines subject to traditional QRs was only 2.7%, slightly lower than the proportion in Sri Lanka in the same year. The removal of QRs up to this point proceeded behind declining but still very high tariff barriers, however, and in 1998 some of the industries protected by the remaining QRs and also by government or government-controlled import monopolies were very large, including, for example most of agriculture and the fertilizer industry. But starting in 1997/98, Pakistan embarked on a radical new trade liberalization program which by 2003 -- subject to some exceptions -- had eliminated all remaining traditional QRs and parastatal import monopolies, while drastically reducing the level and simplifying the structure of import tariffs. The most sweeping reforms occurred in the agricultural sector, where government trading monopolies were abolished and other government interventions greatly reduced.

An exception to the general removal of QRs is the continuation of a long-standing ban on imports from India of products not on a limited positive list of 677 items (corresponding to about 1030 8-digit tariff lines)[24]. Given the considerable potential of this trade, this practice (together with equivalent informal restrictions by India which appear to severely constrain Indian imports from Pakistan) is a major qualification to Pakistan's otherwise generally QR-free trade policies.

Another major exception is the continuation of local-content programs in the auto industry, for which a second three-year phase-out extension was requested at the WTO in December 2003, until December 2006. Pakistan's local content programs started in 1988, but the Uruguay Round TRIMS agreement required developing countries to remove them over five years i.e. by 2000. Pakistan applied at the WTO and obtained a further three year extension, and phased out all its programs except the auto programs between July 2001 and December 2003[25]. Pressure of other WTO members[26] was crucial for this change of policy, but it was also facilitated by reductions in the tariffs on intermediate materials and components, which made the programs less attractive to local firms, since the incentives for going into them is to obtain tariff exemptions or reductions for some imported intermediates and components, in return for commitments to produce or buy other materials and components domestically.

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[20] For more on this see the May 2002 WTO TPR report on India and the Bureau of Standards website <www.bis.org.in>

[21] Quoted from the preamble of the Agreement on Technical Barriers to Trade . WTO, 1994. *Results of the Uruguay Round of the Multilateral Trade Negotiations. The Legal Texts.*

[22] It is provided that the establishment of an Indian office may not be required if there is an agreement between the Indian government and the government of the exporter's country guaranteeing the liabilities of the exporter under the BIS legislation. As of mid-2002, no such agreements had been made.

[23] *Easy Reference Customs Tariff 2002-2003*,p. p/38.

[24] The positive list is in Government of Pakistan, Central Board of Revenue *Pakistan Customs Laws,* 19th edition, 2003-04 (Vol II of the Pakistan Customs Tariff). 77 items were added to the list in 2003.

[25] Details of the phase out of Pakistan's local content programs and the various extension requests at the WTO, are available on the WTO document website (see in particular the following documents : G/C/W/288, 9 August 2001; G/C/W/294, 31 August 2001; G/C/W/478, 22 December 2003; and G/C/W/ 480 30 January 2004). 86 local content (also known as "indigenization" or "deletion") programs) were abolished. They covered a variety of engineering products including various kinds of machines, electrical equipment, and domestic appliances. These programs were administered by the Engineering Development Board (EDB) , a semi-autonomous body which comes under the Ministry of Commerce and Industry. EDB is staffed by engineers and industry experts and also uses specialized private industrial consultants, It has considerable discretion in deciding on the permitted local content levels of individual firms and whether they will be allowed to import particular materials and components at low preferential tariffs. In many respects it resembles the erstwhile Directorate General of Technical (DGTD) in India, which was a key unit administering India's import licensing system until it (DGTD) was abolished in 1991. The phase-out of the 86 engineering deletion programs leaves EDB with just the 16 remaining auto industry programs, and has greatly diminished its role in industrial and trade policy.

[26] Especially the US, the EU and Japan.

As in India, apart from these exceptions, the principal potential source of protective non-tariff restrictions over imports arises through the use of technical regulations and regulations based on health and safety. Many of these are being employed in Pakistan, including restrictions on imports of second-hand products. Protection of local industries is clearly the dominant motive for the latter e.g. the bans on the import of second-hand consumer durables such air conditioners and refrigerators, vehicles, and various types of industrial machinery and equipment.

BANGLADESH

Although Bangladesh has made substantial progress in reducing the use of QRs to protect domestic industry, it remains the only country in South Asia with traditional QRs on imports still in place. Pervasive until the late 1980s, QRs covered nearly 56% of items at HS 6-digit level. Trade liberalization in the early 1990s was characterized by sharp reduction in tariffs as well as significant removal of trade (protection) as well as non-trade motivated QRs (e.g. health, religion, national security). The Import Policy Order 1991-93 saw a major scaling down of QRs, both for trade and non-trade reasons. The process that continued with the IPO 1993-95 stagnated over the next two IPOs: 1995-97 and 1997-02. (Table 2.1)

Table 2.1: Evolution of import restrictions

	IPO 1991-93	IPO 1993-95	IPO 1995-97	IPO 1997-02	IPO 2003-06
Number of items in the control list at the HS 4-digit level	193 (15.6%)	111 (9.0%)	120 (9.7%)	122 (9.8%)	63 (5.1%)
Number of trade-related items in the control list at the HS 4-digit level	79 (6.4%)	19 (1.5%)	27 (1.9%)	28 (2.2%)	24 (1.9%)

Source: WTO Trade Policy Review, Bangladesh 2000; IPO various years

Of the two lists for QRs, the first comprises the list of HS-4 headings subject to bans or restrictions. Some restrictions might not be quantitative per se, but might require fulfillment of certain conditions for imports to be cleared. The problem area is the bunch of trade-related QRs which, though progressively removed over the years, still accounted for some 2% of total HS 4-digit tariff lines (and 0.5% of import value) subject to prohibitions or bans until 2002. The situation changed little under the latest IPO 2003-06 released in March, 2004. In this latest IPO, although the restricted list appears to have been reduced appreciably, they have been replaced by text that explains the host of conditions that need to be fulfilled before import of restricted items could be cleared by customs.

Trade related restrictions are now limited to mainly three categories: agricultural products (chicks, eggs, salt), packaging materials, and textile products. Nearly 40% of all QRs apply to textile products that enjoy the heaviest protection. Although the readymade garment sector imports woven fabrics and grey cloth duty-free under bonded warehouse facilities, the system is cumbersome and susceptible to corruption (through leakage into the protected domestic market).

Some of the ban/restriction on imports is ostensibly applied on grounds of health, religion, environment, culture and so on. Yet a review of all the items in this group reveals that many of the prohibitions or restrictions cannot be justified on these grounds, and are presumably included for protection purposes (e.g. salt, insecticides for mosquitoes). Thus, in the interest of economic efficiency and predictability of impacts, it would still be more meaningful to replace the QRs with equivalent tariffs.

Quasi QRs. Although import licensing was abolished early in the 1990s leading to the near but incomplete demise of the office of CCIE (Chief Controller of Imports and Exports), sundry permits, clearances, and approvals are still required for specific imported products, quite apart from the standard LCA. The net effect of these procedures is akin to import licensing. Furthermore, administrative procedures designed to manage QRs are equivalent to "non-automatic licensing" that implicitly places ceilings on imports of certain products. Another procedure that could effectively serve as a barrier to imports is the required registration of importers. The registration fee itself is unlikely to constitute a significant barrier, but the need to register involves a costly layer of bureaucracy with clear potential for obstruction and abuse.

Bangladesh has been subject to simplified consultations in the GATT and WTO Committee on BOP restrictions since 1993. Bangladesh QRs have been justified under Article XVIII:B (on trade measures taken for balance-of-payments reasons). However, a legitimate invocation of the BOP rationale would apply in order to restrain the general level of imports rather than some specific imports in the event of balance of payments difficulties. With Bangladesh's current account recently approaching surpluses and no apparent pressures on the balance of payments, this rationale no longer appears valid. Since the tenure of IPO 1997-02 has ended and a revision of the IPO is in the works, this is a good time for Bangladesh to consider phasing out the list of 122 restricted items (banned/restricted), as it committed to do in the WTO Committee on BOP in 1999.

State trading, government procurement practices and local content schemes. (a) Quite apart from the import of arms and ammunitions, there is a ban on imports of petroleum products and salt by private importers. The sole importers for these products are state monopolies, Bangladesh Petroleum Corporation and government designated importers, such as Salt Crushers Association, respectively. The restriction on sugar has recently been lifted but the product is subject to a total of 70% tariffs and other levies. Another state trading corporation, TCB, is in the process of being disbanded as its role has all but vanished. (b) Government procurement practices generally discriminate against suppliers from abroad by offering explicit price preference margins or discriminatory tendering. Such practices have effects equivalent to import controls as far as government purchases are concerned. These effects are of course partly mitigated by non-discriminatory imports of similar products by the private sector. (c) The government's cash compensation scheme for selected exports at various rates on fob (15% for leather goods, agricultural and agro-processing products, crushed bone, bicycle and light engineering, textiles, 10% on frozen fish; and 20% on fresh fruit) also constitute indirect barriers to imports.

SRI LANKA

Sri Lanka abolished most of its QRs during its 1977 reforms and continued to remove others during the 1980s and 1990s. By 1998 only 3.7% of its tariff lines were still subject to traditional QRs -- import restrictions explicitly aimed at protecting local industries, other than restrictions justified on health, safety and similar grounds. However these QRs applied to Sri Lanka's principal import substitution food crops: rice, potatoes, chilies, and onions and to a number of industrial products.[27] Like India, Pakistan, and Bangladesh, for many years Sri Lanka had formally justified its QRs at the WTO under the GATT balance of payments clause (Article XVIII:B) on the grounds that they were needed to support the balance of payments. In 1997 this justification was challenged at the WTO, and after consultations a WTO panel recommended that Sri Lanka remove them. Sri Lanka did so in May 1998 by disinvoking Article XVIII:B and removing the import licensing of these products.

[27] Chilies, potatoes and onions were subject to seasonal import licensing in which import licenses to import were only given outside the marketing seasons for the domestic crops. The industrial products still subject to import licensing included a number of drugs and chemicals, timber, motor vehicles, photocopiers etc. They are described in the 1995 WTO TPR report on Sri Lanka.

The finding of the panel reaffirmed the explicit Uruguay Round Undertaking on balance of payments measures that countries cannot pretend that import licensing and other QRs are aimed at supporting the balance of payments when they are not across-the-board, do not include products that are not locally produced, and are invoked in order to protect particular industries. The panel also reaffirmed the need to show some evidence of genuine balance of payments difficulties, and show that, in such a case, standard means of dealing with the problem, such as exchange rate devaluation cannot be used for some reason or need to be supplemented with temporary import licensing. Following this decision, with two principal exceptions, since 1998 Sri Lanka has not been operating any non-tariff import restrictions except those justified under other GATT provisions. But high protection of the import substitution crops has continued with the use of seasonally varying tariffs and specific duties.

The two exceptions are import bans on tea and certain types of spices. Both tea and spices are major export crops. The argument used for banning imports is based on past experiences where inferior imported varieties were blended with domestic varieties and exported as Sri Lankan products, thereby (it is alleged) undermining the reputation of genuine Sri Lankan varieties in export markets. However, it is reported that the bans also reflect pressure from domestic producers of varieties that would be adversely affected if imports were allowed, and it would seem that there must be more efficient ways of dealing with the alleged reputational problem than banning imports[28]. As in other countries, in Sri Lanka GATT-consistent regulations on health and safety and technical standards are also potential sources of discrimination against imports, but very little is known about this aspect of the administration of these rules. In addition, Sri Lanka justifies an import monopoly over wheat (which is not grown in Sri Lanka) under the GATT state trading provision.

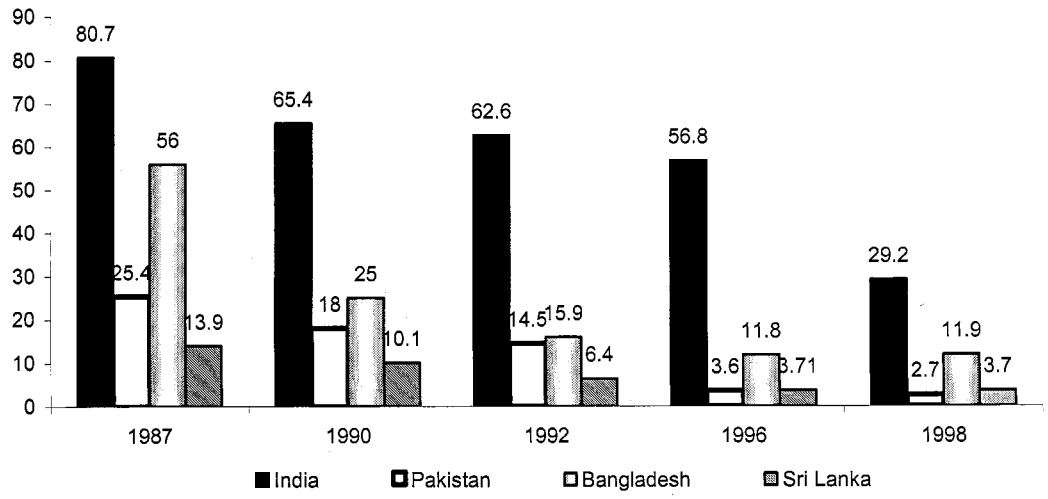
NEPAL

Import licensing and other non-tariff measures have never been widely used in Nepal. An important exception until 1997 was the monopoly a parastatal, the Agricultural Inputs Corporation, held over fertilizer imports. This monopoly was abolished in November 1997 when competing private imports of fertilizers were allowed. At present there are no government import monopolies, except for petroleum products, and the only traditional import QRs (an import ban) is on machine made wool yarn. This has been imposed on the ground that if imports were allowed, the machine made yarn would be incorporated in exported hand-woven artisanal carpets, thereby undermining their "hand-made" reputation and the associated price premium at which they sell[29]. Technical regulations on standards and SPS regulations are a potential source of protective import restriction, but probably less so in Nepal than in India and the other larger South Asian countries, in view of Nepal's more limited technical and administrative capabilities in these areas.

[28] See Chapter IV on export policies for further discussion.
[29] See Chapter IV on export policies for further discussion

BHUTAN

Fig 2.1: South Asia, percentage of HS 6-digit tariff lines subject to QRs, 1987-1998



Sources: 1987, 1990, & 1992, Panagariya (1999); for Bangladesh in 1992 & 1996, Dowlah (2000); for 1998, World Bank.

Bhutan has no explicit QRs, but does have various health and safety and technical regulations which are applicable to imports as well as to domestic products. However, little is know about how these regulations are applied in practice. As pointed out elsewhere, 90 percent of Bhutan's imports are from India, so if there is any non-tariff protection for Bhutanese producers, it is mainly indirect via the NTB regime in India.

MALDIVES

In the past a number of imported products were subject to NTBs: in particular, the import of staple foods was a monopoly of the State Trading Organization (STO). Most of these restrictions were removed quite recently, in 1998, but as of December 2002, import quotas, most of which were allocated to STO, were still being used to regulate imports of rice, sugar and wheat flour[30].

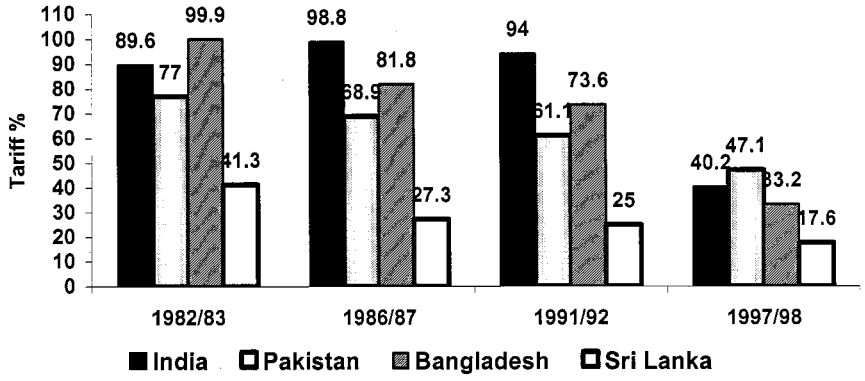
[30] STO TPR Report on Maldives, 2002, pp 38-39.

Chapter 3: Tariffs, Protection and Revenue

Level and structure of tariffs: some comparisons

As noted in Chapter 1, despite the substantial liberalization that occurred during the 1990s, at the end of the decade, South Asia as a whole still remained a heavily protected region with some of the highest tariffs in the world. The tariff reductions that were made during this period were substantial, especially in India, Pakistan and Bangladesh, but tariffs were still very high in 1998, notably in India and Pakistan (Fig 3.1). Since 1998, pre-announced tariff reduction programs, in Pakistan between 1996/97 and 2002/03, and in India between 2002/03 and January 2004, have brought their tariffs down to about half their previous levels. In Bangladesh, however, since the mid-1990s, Customs duty reductions have been largely offset by the increasing use of selective para-tariffs. Currently, including para-tariffs, Bangladesh's average tariffs overall and for industry are by far the highest in the region. Below Bangladesh, the unweighted average tariffs of India, Pakistan, and Nepal are about the same, and Sri Lanka's tariffs remain clearly lower than the average level of tariffs in the other major South Asian countries (Fig 3.2). However, looking more carefully, there are still large differences among the South Asian countries in the structure and sectoral incidence of tariff protection (Tables 3.1 and 3.2). Some general features of these comparisons are noted below. This is followed by more detailed discussions of tariff policies in each of the principal South Asian countries, and some brief notes on tariff policies in Bhutan and Maldives.

Fig 3.1
Tariff Trends, 1983-1998



Before proceeding, a few points should be noted about these cross-country comparisons. First, the average tariffs are unweighted averages of 6 or 8 digit tariff lines and therefore do not necessarily provide a good estimate of the average available tariff protection of existing local industries. This is particularly pertinent for comparisons between India and the other far smaller South Asian economies which have much less diversified production structures, both in agriculture and manufacturing, and therefore have a much larger number of tariff lines which are not protecting domestic production. Since domestic producers have an interest in lobbying to keep tariffs that protect them up, and to keep tariffs on inputs that they use down, this suggests that production or value- added weighted average tariffs are likely to be higher than unweighted tariffs in all the countries including India, but that the excess of production-weighted tariffs over unweighted tariffs is likely to be greater in the smaller countries. Second, the averages are of MFN tariffs and do not allow for preferential tariffs. Third, they do not allow for

exemptions and partial exemptions, of which there are a large number, especially in India, Pakistan and Bangladesh. Fourth, it should be noted that Pakistan, Bangladesh, Sri Lanka and Nepal use other import taxes (described below) as well as Customs duties which are intended to protect domestic producers, or have the effect of doing so. Fifth, all the South Asian countries impose VAT-style indirect taxes on imports, and these taxes have become an increasing source of government revenue, replacing the lost revenues from Customs duties. Except when the tax is deliberately used to provide extra protection by exempting producers of specified products (as in Bangladesh), in principle, these taxes should not affect protection levels of local industries if those industries pay the same VAT rates as imports. But in practice it may be easier to collect the taxes from imports at Customs than in the domestic economy, allowing tax-evading or avoiding local producers to get extra protection against imports. As discussed later, the very high shares of indirect tax revenue coming from VAT-style taxes on imports in several countries (e.g. Pakistan) suggest that they may be having some haphazard protective effects. Finally, it is important to remember that tariff levels only indicate the protection available from tariffs. For many reasons – including strong domestic competition and smuggling from neighboring countries – this available protection may not be used by domestic producers to price their products up to the levels of import prices plus tariffs. Past price-comparison studies in South Asia have revealed a great deal of redundant tariff protection, and it is highly likely that this remains the case throughout the region.

An important feature of tariff policies in South Asia is that Pakistan, Bangladesh, Sri Lanka and Nepal all use import taxes which have protective effects (also known as para-tariffs or, in WTO terminology, "other duties and charges") over and above the protection provided by Customs duties. India also has a long history of using other protective taxes, and only removed the last of these in January 2004. The majority of these taxes were initially imposed to raise revenue, sometimes in the expectation that the need for the extra revenue would be temporary, but in the absence of equivalent taxes on domestic production, they provide extra protection. Some of these para-tariffs are applied across-the-board to all or practically all imports (e.g. Bangladesh's "Infrastructure Development Surcharge") and can be considered as general or normally applied protective taxes which affect all or nearly all tariff lines. Others are selective protective taxes in that they are only applied to selected products e.g. Bangladesh's "supplementary" and "regulatory" duties. The base for the taxes varies: in some cases it is the "assessable value" (usually the cif price or the cif price plus landing charges), in others it is the assessable value plus Customs duties. The para-tariffs employed now or in the recent past in each of the countries are summarized below. More information on them is provided in the sections discussing tariff policies in the individual countries.

India

No para-tariffs since January 9, 2004[1]
Special additional duty (Sadd) 1998/99-January 8, 2004
Special duty 1996/97-1998/99
Surcharge 1999/2000-2000/2001

Pakistan

Income withholding tax
Extra protection for some products through the sales tax (a VAT style tax). The extent and scope of the extra protection is uncertain, however, and no attempt has been made to quantify it in this monograph
Regulatory duties (now mostly phased out)

[1] India introduced a 1% "National Calamity Duty" in its 2003 budget, but its scope so far appears to be very limited (to imports of petroleum oils, high tenacity polyester yarns, and small buses)

Bangladesh[2]

Infrastructure Development Surcharge (IDSC)
Supplementary duties (SD)
Regulatory duties
VAT exemptions for specified domestic products
License fee (abolished in 2002/03)

Sri Lanka

Surcharge on Customs duties (since February 2001)
Ports and Airport Levy (PAL) (since May 2002)
Cess to fund the Export Development Board (since 1981)

Nepal

Local Development Fee
Special Fees
Agricultural Development Fee

Tables 3.1 and 3.2 attempt to allow for the protective effects of these para-tariffs. With the exception of the supplementary duties, regulatory duties, and VAT exemptions in Bangladesh, and the possible use of sales tax exemptions in Pakistan (indicated by a ♦), all of them have been treated as general protective taxes in these tables. For varying reasons the para-tariffs are very difficult to quantify, but it is apparent that not dealing with them would miss an important component of these countries' import policies. For example, with the para-tariffs included (both general and selective) Bangladesh's average protective rate in FY05 is 62 percent higher than its unweighted average Customs duty. Likewise, the average protective rates of Pakistan, Sri Lanka and Nepal exceed their respective unweighted average Customs duty rate by about 8.7%, 18.6% and 31.4%, and before it was abolished, the Sadd tax in India increased average protection from Customs duties by approximately 24%. As well as increasing protection, the number of para-tariffs, their varying bases, other rules for applying them, and exemptions and partial exemptions which may or may not include them, increase the complexity of Customs administration, reduce transparency, and increase opportunities for discretion and negotiation in Customs clearance. Following India, the other South Asian countries should move to a system in which Customs duties are the sole protective import tax.

[2] There is also an "advance income tax" (AIT) in Bangladesh (3.5% of the assessable value of imports) which could have some protective effect in some circumstances. In the absence of information on its incidence, it has not been treated as a protective para-tariff in this survey.

Table 3.1
South Asia: Estimated Unweighted Averages of MFN Customs Duties and Other Protective Import Taxes

	India 2002-03	India 2003-04	India 2004-05	Pakistan 2002-03	Bangladesh 2004-05**	Sri Lanka Jan-04	Nepal Aug-03
All tariff lines							
Customs duties	29	24.8	22.2	17.3	16.3	11.3	13.7
Other general protective taxes	6	6	0	1.5*	3.8	2.1	4.3
Other selective protective taxes	0	0	0	♦	6.4	0	0.0
Total	**35**	**32.7**	**22.2**	**18.8*+♦**	**26.5**	**13.4**	**18.0**
General maximum Customs duty	30	30	30	25	25.0	27.5	25
Other general protective taxes	6	6	0	2*	4.0	3.75	4.5
General maximum: Customs duty+other	**36**	**36**	**30**	**27***	**29.0**	**31.25**	**29.5**
Non-agricultural tariffs							
Customs duties	27.4	24.6	19.7	16.9	15.6	8.8	13.7
Other general protective taxes	5.9	5.8	0	1*	3.9	1.9	4.1
Other selective import taxes	0	0	0	♦*	5.9	0	0.0
Total	**33.3**	**30.4**	**19.7**	**17.9*+♦**	**25.4**	**10.7**	**17.8**
General maximum: Customs duty + other	**36**	**30.8**	**20**	**27***	**29.0**	**31.3**	**29.5**
Agricultural tariffs							
Customs duties	40.6	40.3	40.1	19.6	19.7	24.6	13.5
Other general protective taxes	6.5	6.5	0	3*	3.7	3.5	6.1
Other selective import taxes	0	0	0	♦	8.7	0	0.0
Total	**47.1**	**46.8**	**40.1**	**22.6*+♦**	**32.1**	**28.1**	**19.6**
General maximum Customs duty	100	100	100	25	25.0	27.5	40
Other general protective taxes	8.6	8.6	0	6*	4.0	3.8	4.5
General maximum: Customs duty+other	**108.6**	**108.6**	**100**	**31***	**29.0**	**31.3**	**44.5**
Percent of tariff lines bound at WTO							
Total	72.4	72.4	72.4	36.8	13.2	26	100
Non-agriculture	68.2	68.2	68.2	35	0.9	15	100
Agriculture	100	100	100	89.6	100	100	100
Average of bound tariff levels							
Total	50.6	50.6	50.6	61.4	188.3	50	27.0
Non-agriculture	37.7	37.7	37.7	45.4	50	50	24.5
Agriculture	115.7	115.7	115.7	101.6	188	50	42.3
Specific duties as percent of tariff lines	5.3	5.3	5.3	0.9	0	0.7	0.6

Notes: The averages are of non-preferential MFN rates as given in official tariff schedules and do not allow for SAPTA or other preferential rates. The averages for "Agriculture" are for HS 01-24 and include livestock, fish and fish products, agriculture, processed foods including alcoholic drinks. This definition differs from the WTO definition, mainly by the inclusion of fish and crustaceans (HS 03) and by excluding hides and skins, silk, wool, cotton, and jute. The 2004-05 tariffs in India are the rates which came into force on January 9, 2004 in advance of the budget. The 2002-03 tariffs for Pakistan changed only slightly in 2003-04. All the Customs duty and other rates are percent of assessable value (cif in Pakistan, Sri Lanka and Nepal, cif +landing charges in India and Bangladesh). The protective taxes other than Customs duties that have been allowed for are: in India, the Special Additional Duty (Sadd) , which was abolished in January 2004; in Pakistan, the income withholding tax and domestic sales tax exemptions; in Bangladesh the IDSC tax, Supplementary Duties and domestic VAT exemptions (see text discussion); in Nepal the Local Development Fee, Special Fee and Agricultural Development Fee; and in Sri Lanka the 20 percent Customs surcharge and the 1 percent Port and Airport Development Levy (PAL). No allowance has been made for Bangladesh's advance income tax, which is levied on imports. The estimates do not include the ad valorem incidence of specific duties in the few cases where that is the sole duty. However they include the ad valorem rate in the large number of compound duties (nearly all in India) where the rate applied is the higher of an ad valorem rate and a specific rate. Average tariffs in India would probably be higher if the ad valorem equivalent of the specific duties were estimated. The averages tariffs do not allow for duty exemptions for inputs imported by exporters. They also do not allow for exemptions and partial exemptions which are separate from the general tariff schedules and which are often use and/or user-specific (see text discussion). The "general maximum" Customs duty 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. For Indian agricultural tariffs, the "general maximum" Customs duty rate was considered to be 100% because about 9% of agricultural Customs duties were at this rate. Generally applied protective taxes (such as the Sadd in India, the income withholding tax in Pakistan, and the IDSC tax in Bangladesh), but not selective import taxes are added to the "general maximum" Customs duty to indicate the generally applied maximum level of total protective import taxes. However, no allowance was made for the Advance Income Tax on imports in Bangladesh (see text discussion). "Selective" import taxes (e.g. Supplementary and Regulatory duties in Bangladesh, the effects of domestic sales tax exemptions in Pakistan,) are import taxes which are not applied across-the-board to all or most imported products, but only to some that are specified in the tariff schedule. To estimate average total protective import taxes, these have been averaged across all tariff lines including products to which they are not applied. In interpreting this table, it should be borne in mind that the ad valorem equivalents of specific import duties are often very high in relation to low value imports. This is especially important for India's specific tariffs, most of which are in the HS textile and garment chapters. .Note also that the estimates of the protective effects of Pakistan's income withholding tax are especially problematical, and the averages of these effects even more so: this has been indicated with an asterisk. The average protective effects of Pakistan's domestic sales tax exemptions are even more uncertain and no attempt has been made to quantify their effects on the averages: this is indicated by a ♦. (**) Bangladesh tariffs are recorded as of June, 2004. Protection rates therefore reflect tariff adjustments made in the FY05 Budget announced on 10 June, 2004, which reduced the top CD rate to 25, moved to three-tier tariffs, and significantly rationalized supplementary duties

Table 3.2
Structure of Tariffs in South Asia

Principal Normally Applied Customs Duty Rates and Normally Applied Other Protective Taxes (%)								
India		Pakistan	Bangladesh		Sri Lanka		Nepal	
Jan 2004		2002/03	2003/04		Feb 2004		August 2003	
CD	CD	CD+ other	CD	CD+ other	CD	CD+ other	CD	CD+ other
0			0	0/4	0	1	0	2.5
					3	4.3		
5	5	6.9					5	7.5/9.5
			7.5	11.5	6	7.6		
10	10	12.0					10	12.5/14.5
					12	14.2		
15			15	19			15	19.5/24.5
					16	18.6		
20	20	22.1						
			22.5	26.5				
25	25	27.2					25	29.5
					27.5	31.3		
30			30	34				
Approximate percentage of tariff lines subject to ad valorem Customs duty rates in excess of "normal" maximum								
6.9%		1.1%	Zero.		0.9%		5.2%	
Approximate percentage of tariff lines with total protection rates (inclusive of selective para-tariffs) in excess of "normal maximum" Customs duty + general para-tariffs								
2.8%		1.1%			0.9%		5.8%	
Number and range of "above normal" ad valorem Customs duty rates								
17 rates 35% to 182%		10 rates from 40% to 250%	Zero. SD, RD & VAT used for extra protection		3 rates: 75%, 100% and 125%		3 rates: 40, 80 and 130%	
Approximate percentage of tariff lines subject to specific Customs duties								
5.3%		0.7%	Zero. But use tariff values		0.7%		0.6%	

Notes: CD=Customs duty. SD (Bangladesh)=Supplementary Duty, RD(Bangladesh)=Regulatory Duty. See text for a description and explanation of the other protective import taxes. Protection rates separated by a slash mean that there are two "normal" total protection rates corresponding to a single Customs duty rate.

Fig 3.2
Average Tariffs in South Asia 2003 and 2004

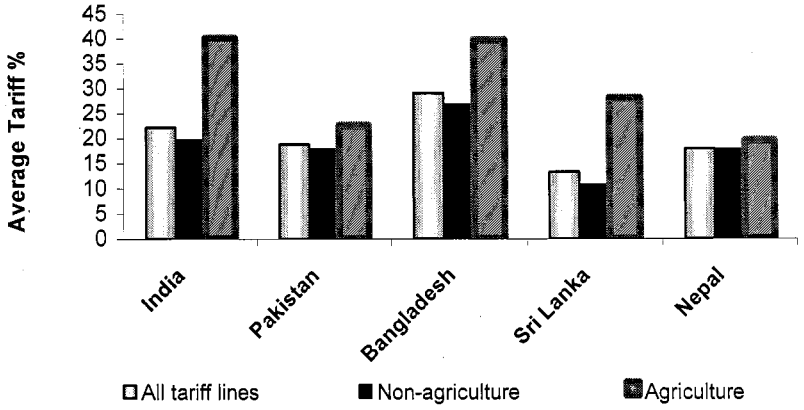


Table 3.1, Table 3.2 and Fig 3.2 bring out a number of important points about current tariff policies in South Asia:

- There has been a major reduction in the average Indian *ad valorem* tariff since 2002/03, which has come down from 35% to 22.2%. Whereas previously Indian tariffs were much higher than tariffs in the other South Asian countries, on average they are now well below Bangladesh's tariffs, and only about 3 to 4 percentage points higher than tariffs in Pakistan and Nepal.
- However 5.3% of India's tariff lines (mostly textiles and garments) are compound tariffs in which the imported product is subject to the higher of *ad valorem* or specific customs duties, but only the *ad valorem* rates were used in estimating average Customs duties. The average Indian Customs duties would be higher than shown here if the *ad valorem* equivalent rates applicable to textile and garment imports from low-price sources were estimated. By contrast, fewer than 1% of tariff lines in the other countries are specific tariffs, and Bangladesh does not explicitly use specific tariffs. In the past Bangladesh has effectively done the same thing by systematically using tariff values instead of actual invoice values as the base for Customs duties and other import taxes. This protection technique is not picked up in protection estimates based on *ad valorem* Customs duties and information on other import taxes. In principle Bangladesh is no longer using tariff values to provide additional protection.
- Bangladesh has by far the highest tariffs in South Asia. After allowing for para-tariffs, the average protective rate has declined only slightly since 1995/96, from 32% to 29.2% in 2003/04, with a sharp drop to 26.5% occurring in the budget of FY05. Although average Customs duties declined substantially during these 10 years, from 28.7% to 16.3%, this was almost entirely offset by increases in para-tariffs, which went up from and average of 3.3% to 6.3%. The IDSC tax is applied generally to all imports, but other import taxes (see later discussion) are being used to protect favored domestic industries which as a result benefit from very high protection levels in excess of the normal maximum Customs duty rate. This is principally being done by the imposition of "supplementary" duties on top of Customs duties and the IDSC tax, but also by exempting some domestic industries from VAT even though VAT is paid on imports, and by imposing "regulatory" duties. A large number of new regulatory duties were imposed in 2003/04 but taken off in 2004/05.
- On average, protective tariffs are about the same in Pakistan and Nepal and slightly lower in both countries than in India, but Sri Lanka's are markedly lower than tariffs in the other South Asian countries. With the important exception of agriculture, Sri Lanka is a low-to-medium tariff country by the general standards of developing countries.

- In all five countries, "agricultural" tariffs (which include tariffs on fish, livestock, and processed foods as well as agricultural products)[3] exceed non-agricultural tariffs. They are only moderately higher in Pakistan and Nepal, but considerably higher in India and Bangladesh and also in Sri Lanka (almost three times the level of industrial tariffs). Agriculture was left out of India's three year tariff reduction program, and in fact since the final phase-out of QRs in April 2001, Indian agricultural tariffs have been going up. They are presently about double industrial tariffs (40.1% versus 19.7%), and many tariffs protecting even exportable agricultural commodities such as tea and coffee, are clustered at 100%. Bangladesh's para-tariffs protecting agricultural, livestock marine product and food processing industries were sharply increased in 2003/04.

Table 3.3

Rankings of Average Tariffs in South Asia in Relation to Average Tariffs in Other Developing Countries

	All products	Manufacturing and all other	Agriculture
India	10	12	7
Pakistan	15	18	26
Bangladesh	5	7	10
Sri Lanka	42	59	12
Nepal	22	20	42

Notes & sources: South Asia unweighted average tariffs from Table 3.1. Other developing country average tariffs from files kindly provided by Francis Ng, World Bank. The other developing country ranking for all products relates to average tariffs in 134 countries in 2002. The rankings for "manufacturing and all other" relate to 106 developing countries in 1998, 1999, or 2000 (most in 2000). The rankings for agriculture are for the same countries and years as in the "manufacturing and all other" set, except that Nigeria has been added, and for it and 9 other countries 2002 averages have replaced the earlier tariff averages. The rankings are in descending order of average tariff levels.

[3] "Agricultural" tariffs in these comparative tables refer to products covered by HS Chapters 01-24. This definition is not the same as the WTO Agreement on Agriculture definition, principally by including fish and crustaceans in HS Chapter 03, and by excluding hides and skins and fibres such as cotton, wool and jute.

Table 3.4

Average MFN tariffs in South Asia compared with average tariffs in some other large and medium size developing countries

All products (134 countries)				Agriculture (134 countries)			
	Average tariff (%)	Rank	Data year		Average tariff (%)	Rank	Data year
Morocco	33.4	1	2002	Morocco	53.6	1	2002
Tunisia	30.2	3	2002	Turkey	51.6	2	2001
Bangladesh	**26.5**	**5**	2004-05	Tunisia	44.7	4	2002
Iran	23.9	7	2002	Korea	43.5	5	2002
Nigeria	23.4	8	2002	**India**	**40.1**	**7**	2004-05
India	**22.2**	**10**	2004-05	Iran	35.7	9	2002
Pakistan	**18.8**	**15**	2002-03	**Bangladesh**	**32.1**	**10**	2004-05
Egypt	18.4	20	2002	**Sri Lanka**	**28.1**	**12**	2003-04
Nepal	**18.0**	**22**	2003-04	Mexico	25.7	14	2002
Mexico	16.2	30	2002	Nigeria	23.0	25	2002
Vietnam	15.0	32	2001	**Pakistan**	**22.6**	**26**	2002-03
Ghana	14.7	34	2000	Ghana	20.2	37	2000
Thailand	14.7	35	2002	Vietnam	19.7	40	2001
Sri Lanka	**13.4**	**42**	2003-04	**Nepal**	**19.6**	**42**	2003-04
Turkey	12.6	47	2001	Egypt	18.2	46	2002
Korea	12.6	48	2002	China	17.9	50	2002
Brazil	12.3	51	2002	Thailand	16.2	56	2002
China	12.3	52	2002	Colombia	15.9	59	2003
Argentina	11.8	62	2001	Median	15.1		
Colombia	11.7	63	2003	Argentina	12.3	85	2001
Median	11.2			Brazil	11.7	90	2002
Malaysia	8.8	86	2002	Philippines	10.5	101	2003
Indonesia	7.2	99	2002	South Africa	10.2	104	2001
Chile	7.0	101	2002	Indonesia	8.4	115	2002
South Africa	6.4	106	2001	Chile	7.0	119	2002
Philippines	5.1	120	2003	Iran	3.1	128	2000
				Malaysia	3.0	129	2002
Mean	11.7			Mean	16.7		

Notes: The average tariffs and rankings for "all products" are for 139 developing countries from data provided by Francis Ng, DECRG, World Bank. The averages for the South Asian countries are as indicated in Table 3.1: the averages for the other countries are for 2002, from a file kindly provided by Francis Ng. The averages and rankings for "Agriculture" include fisheries and livestock and are for the years indicated in the Table. The data is from a file provided by Francis Ng which provides average agricultural tariffs for 106 developing countries in 1998, 1999 or 2000 (most in 2000). The averages given in this file for the five South Asian countries was replaced by the later estimates shown in this Table, and for 9 other countries by averages for 2002 also shown in this Table. In addition average agricultural tariffs for Nigeria (not included in the original data set) in 2002 were added, giving a total data set of 106 developing countries.

- Tables 3.3 and 3.4 gives an indication of where average tariff levels stand in relation to tariffs in other developing countries. Overall, 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 the world, ranking fifth after Morocco, Tunisia, 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 the 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.
- Table 3.1 compares the "general maximum" Customs duty rates and general maximum total protective rates of the five countries. The latter includes the normal maximum customs duty and other normal protective taxes which would be routinely added unless the particular product imported were exempted. The "general" or "normal" maximum Customs duty is defined as the maximum rate which applies to at least 5% of total tariff lines, and above which there are no more than 10% of total tariff lines. In each country there are products subject to customs duties and/or other protective taxes which take the protective rates for these products above (often far above) these general maxima (see later discussion). For all tariff lines, the general maxima in the table are defined as follows :

  India: General maximum customs duty 30%. This general maximum is because of the large number of agricultural tariffs clustered at 30%. The general maximum non-agricultural tariff is 20%.
  Pakistan: General maximum customs duty 25%+ approximate protective effect of income withholding tax 2%=27%
  Bangladesh: General maximum customs duty 25%[4] + IDSC tax 4%=29%.
  Sri Lanka: General maximum customs duty 27.5% + surcharge 2.75% (10% of customs duty) + PAL 1%=31.25%
  Nepal: General maximum customs duty 25%+other taxes 4.5%=29.5%.

- The "top down" approach to tariff reduction followed in all the South Asian countries has greatly reduced the number of normally applied tariff bands or "slabs" (Table 3.2). Leaving aside above-normal peak tariffs and considering just Customs duties, Pakistan is now operating with a relatively simple, four-rate structure (5,10, 20 and 25 percent). Bangladesh uses three non-zero rates: 7.5, 15, and 25. Including zero, Nepal is using 5 rates, Sri Lanka 6, and India 7. However, the structure is more complex in Nepal once the para-tariffs are taken into account, since the Agricultural Development Fee is only charged on imported agricultural products, so that there are two total protective rates corresponding to three of the Customs duty slabs. In this regard, the abolition of the Sadd tax in India was responsible for a major simplification, since immediately prior to its abolition there were a large number of total protective import tax slabs (41 in 2002/03[5]) associated with the seven "normal" Customs duty slabs. The reductions in the number of normally applied import duty rates that have occurred in all five countries should have simplified and speeded up Customs administration, but the increased use of para-tariffs has worked in the other direction, especially in Bangladesh since the mid- 1990s[6]. During this period, Bangladesh reduced the number of Customs tariff rates it uses, but this advance in simplicity of administration has been more than offset by the increasing use of other import taxes and the unnecessarily complex ways in which they are related. The expansion of preferential tariffs under SAPTA and the various other preferential trade agreements together with the rules of origin that go with these agreements, have also increased the

[4] The general maximum CD rate was reduced to 25% in the new budget of FY05.
[5] Arun Goyal, 2002. *Easy Reference Customs Tariff 2002-2003.* Ready Reckoner of Customs Duties 2002-2003, p. xv.
[6] In Bangladesh there are just 4 normal Customs duty rates, but some zero rated Customs duty items pay the IDSC tax whereas others do not.

complexity and reduced the transparency of tariff structures and administration in all the South Asian countries.

- Tariff setting in South Asia is everywhere guided by a principle that appears to be a general article of faith in the region, even though, from the viewpoint of economic efficiency, it has no economic logic. Low tariffs are imposed on raw materials; higher ones for processed intermediate materials, components and machinery; and highest for final consumer goods. If actually applied in this way, the processing margins (value-added) and effective protection available from tariffs would increase along this chain, with the lowest rates for raw materials and the highest for final consumer goods. The implementation of the principle has been very imperfect, but even so tariff structures in Pakistan, Bangladesh, Sri Lanka, and Nepal are quite escalated. The structures are much flatter in India, however, with two thirds of tariff lines including many intermediates concentrated at the top "normal" rates. This reflects the much more diverse industrial structure in India and the lobbying power of industries producing intermediate materials. Allowing for the large numbers of full and partial tariff exemptions in India would probably change this picture somewhat: these are typically the outcomes of lobbying efforts of producers endeavoring to reduce the costs of their inputs and equipment so as to raise their processing margins and effective protection.
- As noted above, each country has tariff peaks, that is tariff lines with basic Customs duties and para-tariffs exceeding the general maximum rates. Table 3.2 summarizes some information on these peaks. Inclusive of specific duties, India has the largest number, especially tariffs protecting its agricultural, textiles and garments and automobile sectors. India uses a large range and large number of above-average Customs duty rates: around 830 eight -digit tariff lines at 17 different levels between 35% and 182% as well as about 640 compound rates -- tariffs which are the higher of an *ad valorem* rate or a specific rate -- with specific components that can correspond to very high *ad valorem* rates at low cif prices. Pakistan has very few tariff peaks, although protecting important industries (edible oils and automobiles.) Bangladesh uses other taxes, especially its "supplementary" and "regulatory" duties, rather than Customs duties to provide extra protection. In 2003/04, approximately a fifth of Bangladesh's tariff lines were subject to one or more para-tariffs, and allowing for these, a corresponding proportion (about 14 percent) exceeded the "general maximum" rate of 34% shown in Table 3.2. Sri Lanka uses specific duties to provide high protection for some key import-substitution food crops, but otherwise imposes only a few above-normal Customs duty rates on industrial products. A surprisingly large proportion (5.2%) of Nepal's tariff lines exceeds its general maximum rate of 29.5 %. Most are at 44.5% with a few at 83% and 141.5%, plus some specific duties.
- India has bound 68% of its non-agricultural tariff lines at the WTO, mostly at 40% but with some intermediate products at 25%. In recent years these bindings have been important in constraining tariff increases. Fewer non-agricultural tariff lines are bound in Pakistan and Sri Lanka, however, and at higher rates (mostly 50%). However, the bindings have little influence on tariff setting in these countries, in part because both countries have had relatively strong and consistent reduction programs for non-agricultural tariffs. In Bangladesh practically no non-agricultural tariff lines have been bound (0.9% of the total), and there is therefore practically no external WTO constraint on tariff increases. Nepal acceded to the WTO in December 2003, and like other recently acceding countries it has been required to bind all its non-agricultural tariffs and also all its para-tariffs ("other duties and charges"). These bindings (average 24.5%) are much lower than the bindings of the other South Asian countries and are likely to constrain future tariff increases.
- Under the Agreement on Agriculture all agricultural tariffs were required in principle to be bound. However, as is apparent from Table 3.1, the ceiling bindings requested by India, Pakistan and Bangladesh and agreed to by other WTO members were mostly high-to-prohibitive. In India and Bangladesh the lack of any constraint from WTO commitments is now showing up in agricultural lobby groups pushing for and obtaining high-to-very-high applied tariffs with little or no domestic resistance (see later discussion of agricultural trade policies). The general binding of 50% in Sri Lanka may be providing some constraint on agricultural tariff increases, even though some

agricultural tariffs (e.g. specific duties on potatoes) have gone well above this level without so far evoking protests from other WTO members. Likewise, Nepal's agricultural bindings (average rate 42.3%) may constrain future tariff increases.

The following sections provide a more detailed account of recent tariff policies in India, Pakistan and Bangladesh, Sri Lanka and Nepal, and brief commentaries on a few aspects of these policies in Bhutan and Maldives. Special attention is paid to Bangladesh owing to recent and not well known changes which have reversed many of its earlier liberalizing tariff reforms.

Table 3.5

India: Average Protective Import Taxes 1990/91- 2004/05

	Unweighted	Import weighted
1990/91	128	87
1991/92	n.a.	n.a.
1992/93	94	64
1993/94	71	47
1994/95	55	33
1995/96	40.8	27.2
1996/97	38.6	24.6
1997/98	34.4	25.4
1998/99	40.2	29.7
1999/00	39.6	30.2
2000/01	n.a.	n.a.
2001/02	38.4	n.a.
2002/03	35	n.a.
2003/04	32.7	n.a.
2004/05	22.2	n.a.

Sources and notes: Includes estimated protective incidence of other import taxes as well as Customs duties. 1990/91-1999/2000 from World Bank (2000, January). Annex Table 6.6. 2001/02 and 2002/03 are estimates starting from the unweighted average Customs duty in 2001/02 of 32.3% reported in the 2002 WTO TPR report on India, and an estimated average Customs duty in 2002/03 of 29 percent reported by Goyal (*Easy Reference Customs Tariff)*. Up to and including 2001/02 the averages are of approximately the same number of consistently defined 6-digit HSC tariff lines (about 5400 lines in all.). From 2002/03 they are averages of 12076 8-digit tariff lines and are not directly comparable with the pre-2002/03 averages. The 2004/05 averages are calculated from estimates of the distribution of Customs duties following the 2003/04 budget provided by Arun Goyal, as modified by changes announced on January 8, 2004 and published on the Ministry of Finance (Central Board of Excise and Customs) website All the rates are percent of assessable value (cif+1%).

India

Before the 1991/92 reforms, Indian tariffs as actually applied were probably the highest in the world. Starting from already high levels in the 1970s, they peaked in 1988, averaging between 120% and 140%. A "tops down" tariff reform process started in mid 1991 which combined reductions of tariffs on selected products to levels below successively announced maxima, and aimed for a maximum tariff of 30% on intermediate and capital goods and 50% on consumer goods by 1997/98 (even, if possible, by 1996/97). Because many tariffs had been redundant during the 1980s, because of the very large real Rupee devaluation between the mid-1980s and 1991/92, the tariff reduction program carried out during the first half of the 1990s proved quite painless for most producers of intermediates and machinery and equipment, even though the QRs which had previously protected them had been removed. In contrast, producers of industrial consumer goods and the agricultural sector continued to be protected by QRs which in most cases amounted to a *de facto* import ban. During the Uruguay Round negotiations India bound about two thirds of its industrial tariffs at somewhat lower rates than the 1991 reform objectives - mostly at 40% and 25% for a proportion of intermediates and capital goods. Starting in 1995, these bound rates came down in steps from the applied levels at the time of the Round and became operative at the new announced levels in 2001/02. Applied tariffs continued to follow their pre-announced planned decline until 1997/98 when they reached 34.4% versus 128% at the beginning of the process in 1990/91

(Table 3.5). After 1997/98, for reasons discussed in Chapter 1, the decline was reversed. On average, tariffs increased by about 5 percentage points in 1998/99, and remained above the 1997/98 levels until the first stage of an announced new reduction program started in 2002/03. The increase in protective tariff levels during the four years 1998/99-2001/02 was due to the introduction of other protective import taxes on top of Customs duties, rather than higher Customs duties themselves. The protective taxes and the resulting total protection corresponding to the normal maximum Customs duties are shown in Table 3.4. As in the other South Asian countries, the use of additional import taxes greatly complicated and reduced the transparency of Customs administration, and this aspect of the reversal of the earlier trade liberalization during these years could well have been as economically costly as the consequences of the higher protection levels.

The surcharge, which followed an earlier "Special duty", was discontinued in the 2001/02 budget but the Special Additional duty (or SAdd) was retained until January 2004. This tax was levied at 4% of (Assessable value + Customs duty + Additional duty). "Additional duty" is a VAT-type tax applied to imports at the same rate as the Central government VAT (CENVAT) on domestic sales, generally at the rate of 16%. The SAdd tax was introduced in the 1998/99 budget, initially at 8% but soon reduced to 4%. It was justified as offsetting the protection-reducing effects of state and Central sales taxes (frequently but not always 4%) applied to sales of domestically produced machinery and intermediate inputs, but which would not be applied if the using firms imported them directly. But goods imported by intermediaries are subject to normal sales and other domestic taxes when they are resold, so that for them the SAdd tax provided extra protection over and above the Customs duty. In relation to the assessable value of the import (the CIF price + 1%) the extra protection went up with the Customs duty rate and the rate of additional duty. For example, with the general additional duty rate of 16%, the extra protection with a 15% Customs duty was 5.3%, giving a total protective rate of 20.3%, and the extra protection with a 30% Customs duty was 6%, giving a total protective rate of 36%. The protection for producers of equipment and intermediate inputs which the users had the option of importing directly, was the same as the Customs duty rate.

Table 3.6
India: Normal maximum Customs duties and import taxes, 1996/97-2004/05

	Customs duty (non-agriculture)	Customs duty (agriculture)	Special duty/ surcharge	Additional duty (CVD)	SAdd	Total protective rate(non agriculture)	Total protective rate (agriculture)
1996/97	50	50	2	18	-	52	52
1997/98	40	40	5	18	-	45	45
Apl-June 98	40	40	5	18	8	58.6	58.6
June 98/99	40	40	5	18	4	51.8	51.8
1999/00	40	40	0	16	4	46.5	46.5
2000/01	35	35	3.5	16	4	44.9	44.9
2001/02	35	35	-	16	4	41.3	41.3
2002/03	30	100	-	16	4	36	108.6
2003/04	25	100	-	16	4	30.8	108.6
2004/05	20	100	-	16	-	20	100

Notes: The Customs duties are the maximums of the normally applied rates in each year. Higher Customs duties than these were applied on some products. The general maximum rate was the same for agriculture and non-agriculture until 2001/02, after which agricultural tariffs were increased while other tariffs were reduced.. A "special" customs duty, initially at 2% percent and then at 5% of assessable values, was applied on top of Customs duties between 1996/97 and 1998/99. In 1999/2000 this was replaced by a surcharge equivalent to 10% of the Customs duty rate, but only on Customs duties of 35% or less. This surcharge was dropped in 2001/02. The "additional" or "countervailing" duty is the equivalent of VAT-style excise taxes on domestic transactions and in principle does not provide protection to domestic production. A "Special Additional Duty" (SAdd) was introduced in 1998/99, initially at 8% and then reduced to 4%. It was abolished in January 2004. The base for the SAdd tax is explained in the text.

The plan to bring the general maximum Customs duty rate down from 35% to 20% in three steps, was announced in 2001/02 and was implemented with 5% percent reductions in the 2002/03 and 2003/04 budget, and finally in an unexpected reduction starting from January 9, 2004, in advance of the postponed budget which is normally on March 31 each year. The abolition of the Sadd tax on January 9 was not pre-announced however, and both reforms together amounted to a large single-step reduction in protective import taxes. After this reform, the unweighted average tariff was about 22.2% compared to 32.7% previously, and was much lower than the estimated combined average protection rates (Customs duties+ Sadd) of 35% in 2002/03 and 38.4% in 2001/02. Average non-agricultural tariffs came down even further, to about 19.7% from 30.4% previously. The tariff structure was also simplified, above all by the abolition of the Sadd, but also by reducing the number of exceptions that previously existed to the general Customs duty ceiling for non-agricultural products. The principal exceptions are now a number of steel tariff lines (25% tariffs) and automobiles, motor cycles and scooters (60% tariffs). Most other exceptions at higher *ad valorem* rates than the announced "maximum", which were previously scattered throughout the HS chapters, were cleaned out. Following these reforms, 76.3% of all tariff lines, and 87.2% of non-agricultural tariff lines, are at 20%.

In the first stage of this reform program, the general maximum agricultural tariff, which had been 35%, was reduced to 30% along with the non-agricultural tariffs. However, at the same time many agricultural tariffs were increased very substantially, and as defined for purposes of comparison with the "general maxima" for agricultural tariffs in the other South Asian countries (see above), the Indian general maximum has since been 100%. The unweighted average agricultural tariff (now equivalent to average Customs duties) is just above 40 percent, lower than the previous estimated average protective tariff owing to the abolition of the SAdd tax, but still among the world's highest: about number 4 among 105 developing countries. 76.5% of agricultural tariffs are at 30%, 18.4% (including a large number of 100% tariffs) exceed 30%, and only 5.1% of agricultural tariff lines are less than 30% (Table 3.7 and Fig 3.3).

Table 3.7

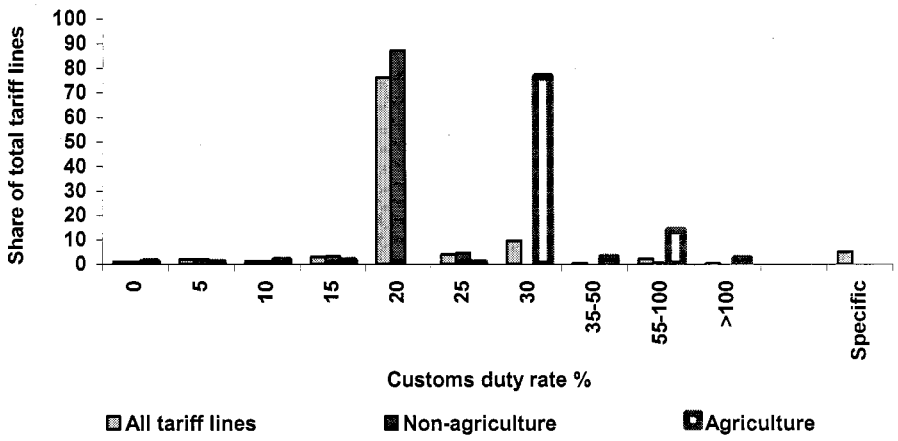
India January 2004

Distribution of Tariff Lines Percent

Tariff rate%	All lines	Non-ag	Ag
0	0.99	1.00	0.86
5	1.88	2.06	0.59
10	1.28	1.23	1.58
15	3.02	3.25	1.45
20	76.25	87.21	0.00
25	4.11	4.62	0.53
30	9.66	0.04	76.55
35-50	0.33	0.00	2.64
55-100	2.21	0.56	13.70
>100	0.28	0.02	2.11
Specific	5.10	n.a.	n.a.

Note: The ad valorem component of compound tariffs (i.e. tariffs which are the higher of an ad valorem or a specific component) have been used in calculating the distribution of ad valorem tariff rates. Specific (nearly all compound) tariffs account for about 5.1% of total tariff lines

Fig 3.3
India January 2004
Distribution of Tariff Lines



As noted previously, Indian non-agricultural tariffs are much less dispersed than non-agricultural tariffs elsewhere in South Asia The concentration of rates at the top of the range is due to the "tops down" process of tariff reduction as a result of which more and more tariff lines were reduced to the top general maximum rate of 20%, starting from 50% in 1996/97. However, the extent to which this process reduces tariff escalation and effective protection depends on the extent of tariff exemptions and partial exemptions for intermediate inputs not captured in this analysis of the general tariff schedule, and the success of affected industries in obtaining extra protection in other ways. Strong pressures on both these fronts have been apparent in India in recent years.

As regards exemptions and the more common partial exemptions, in 2003-04 a "Jumbo Exemption" Customs notification lists 433 items for which some kind of exemption is allowed, each item corresponding to an HS code (two digit, four, six or eight digit) and many supplemented by one or more of 46 product lists which contain over 1100 detailed product descriptions. The vast majority of these exemptions are for intermediate material inputs or for machinery and equipment items including spare parts and may involve the basic customs duty, the additional (VAT-style) duty, and in the past the Special Additional duty (SAdd), or any combination of these. The exemptions are sometimes for specific subcategories of HS codes, for products to be used as inputs in the production of specified products, for use by particular firms or industries (but not other users of the same products), or even for particular (non-preferential) foreign supplying countries. The Indian "Jumbo Exemption" notification was introduced in 1996 to consolidate and bring greater clarity to the previous impenetrable maze of exemption notifications, but since then the jumbo has grown, and the total number of exemptions now appears to be at least double the number in 1996. There is no published quantitative analysis of the incidence and effects of these exemptions, and the 2001/02 WTO TPR team found them too complex to incorporate in their analysis of India's tariff structure[7]. The exemptions generally reflect the lobbying power of industries which in this way reduce the cost to them of raw materials and components and of the machinery that they use. While increasing these industries' processing margins, at the same time the exemptions squeeze the processing margins of actual or potential domestic producers of the intermediate products and machinery, many of which may face relatively high tariffs affecting the prices of their intermediate inputs. In this regard, it is probable that there have been some especially strong disprotective

[7] WTO 2002, India TPR report, p.32..

effects for the machinery industries, since many of the exemptions cut machinery tariffs to 5%, most of which would otherwise be 20% at present[8]. These industries face considerably higher tariffs for many of their inputs e.g. steel tariffs which are currently 25% and which in the recent past have been supplemented by anti-dumping duties and import restrictions implemented by the Bureau of Indian Standards. As with many other aspects of tariff reform, the simplest and most direct way of dealing with this problem is to get tariffs down to much lower levels so that the costs to producers of negotiating and lobbying for exemptions begin to exceed the benefits. This is reported to be happening in Pakistan where many intermediate input and machinery tariffs are now about 10 percent or lower (see discussion below).

In addition to the separate treatment of agriculture and exemptions for inputs, the removal of most industrial QRs and the descending general Customs tariff ceiling have also generated pressures for other forms of protection. These include the following:

Increasing use of specific tariffs. The number of these (mostly compound tariffs) increased from 0.2% of total tariff lines before 2001 to about 5.3% of total tariff lines at present. Most are used to protect textile fabrics and garments against low priced import competition. The *ad valorem* equivalents of some specific duties estimated in the chapter on the textile and clothing sector, turn out in some cases to be prohibitively high, ranging from 50 percent to over 100 percent. Among other things, even with generous preferences under SAPTA (e.g. 50% or 60% for garments from Bangladesh) these specific duties make it impossible or very difficult for other developing countries to compete in the Indian market.

Anti-dumping duties. Starting in 1993, anti-dumping has grown into a major activity in India. Of the more than 150 cases completed, nearly all have resulted in the imposition of specific duties on imports from particular firms and countries on top of normal import duties. On-going research on this activity shows that the *ad valorem* equivalent of the anti-dumping duties imposed ranges from around 10% to over 100% of normal international prices. The total resulting import tariffs are often prohibitive. This now-major activity in India is steadily undermining much of the other efforts -- including tariff reduction -- to liberalize the trade regime, and India's example is influencing the other South Asian countries to embark on anti-dumping as well. Because of its importance it is discussed separately later in this chapter.

Small scale industry (SSI) excise tax exemptions or partial exemptions. These exemptions as intended give a tax advantage to Indian SSI firms over larger Indian firms, but also benefit the SSI firms in competing with imports that pay the equivalent of the normal domestic excise taxes. For imported products subject to a Customs duty of 20% and the normal "additional duty" of 16%, the protection rate for small domestic producers which are exempt from excise duty is 39.2%. Because of the dominant role of small scale firms in fabric and garment production (see Volume II, Chapter 3) the scope of the extra protection provided in this way is potentially greatest in these sectors. For cotton fabrics and cotton garments, the *ad valorem* Customs duty of 20% and the additional duty of 8% are equivalent to an import protection rate of 29.7%, and for non-cotton fabrics and garments (Customs duty 20%, additional duty 10%) the protection rate is 32%. The extra protection from the SSI excise tax exemption would be greater than this if specific rather than *ad valorem* Customs duties are operative. On the other hand, at present the excise exemption applies to enterprises with annual sales of up to only Rs 20 lakhs (approximately $US 45,000), and with the exemption these enterprises cannot offset excise taxes included in the cost of their inputs. For these reasons the role and scope of the SSI excise tax exemptions appears to be diminishing,

[8] For example, in 2003, three plantation industries (coffee, tea and rubber) lobbied for and obtained low 5% tariffs for specialized and non-specialized crop machinery for which the normal protective tariff was then 25%. In this case, controls would be needed to ensure that the non-specialized equipment is only used in these three industries (Customs Notification No 175, 10/12/2003)

both as a subsidy for small firms relative to larger firms, and as a source of extra protection for small firms against import competition[9].

Other excise tax exemptions. Even though the basic value added structure of the Indian excise tax system is having a key role in limiting the distortive consequences of varying excise tax rates and exemptions, changes continue to be made, some of which are targeted and *ad hoc* with effects on import protection rates. For example, in September 2003, in order to encourage investment in India's north eastern states (Arunchal Pradesh, Assam, Manipur, Megalhaya, Mizoram, Nagaland and Tripura) tobacco and cigarette manufacturing firms were subjected to special *ad valorem* excise tax rates on sales of units in these states, which are much lower than the normal specific excise tax rates applied to domestic sales in other parts of India and on imports[10]. These concessions are designed to make it more attractive to produce in plants located in these areas than in plants elsewhere in India, but in the process the concessions also raised the protection rates for these plants in relation to imported tobacco products, in particular from Bangladesh and other neighboring countries. The use of excise tax concessions in the pursuit of regional and other objectives has a long history in India, and in the past the impact on trade could be and was ignored. This should no longer the case in an era of much more open and transparent trade policies when discriminatory actions of this kind may conflict with the interests of trading partners and with basic international trade rules, such as the WTO national treatment principle.

Tariff rate quotas applied to a number of agricultural commodities (see later discussion of agricultural trade policies).

The use of values other than actual cif prices ("tariff values") as the base for *ad valorem* import duties. This is the current technique, which has replaced specific tariffs, for protecting the edible oil industry. Rather than changing specific duties, the tariff values are regularly altered so as to increase or decrease protection rates as world prices vary. The same technique is also used for a number of industrial products (e.g. brass scrap)[11].

The use of technical standards and regulations (TBT) to restrict imports (already discussed in Chapter 2)

Limiting the sea and land Customs posts at which certain products can clear Customs (already discussed in Chapter 2).

The use of sanitary and phyto-sanitary standards (SPS) to restrict imports (see Chapter 2 and the chapter on agricultural trade policies in Volume II).

Pakistan[12]

Tariff reduction was a key part of trade liberalization started in the 1980s but continued quite slowly and cautiously during the 1990s. As discussed below, Pakistan's income withholding tax and sales tax also provide some protection, but the liberalizing reforms have focused on Customs duties. In 1996/97 Pakistan's Customs duties were still very high (unweighted average rate 41.7%) with a complex and opaque structure including large numbers of rates or "slabs" (14 "normal" *ad valorem* rates) and many

[9] In a review of changes in the excise tax rules in the textile and garment industry, Goyal (Weekly Index, XX, No 06, May 6-12, 2003) comments: "Thus the exemption covers only single loom owners or the five machine garment boutiques run by lady entrepreneurs in garages and barsatis. The department of revenue has ensured that coverage is limited to the very small".

[10] These concessions are described in Goyal, Weekly Index, XX Nos 23& 24, September 3-16, 2003.

[11] On brass scrap, see Goyal, Weekly Index XX, No 25, Sept 17-23, 2003.

[12] More detail on many of the topics covered in this section are in a recent World Bank report prepared by Philip Schuler. World Bank, 2004, March. *Pakistan Tariff Rationalization Study.*

exemptions and partial exemptions. That year, however, saw the start of a new reduction and simplification program that was consistently implemented in successive budgets up to and including the 2002/03 budget, after which the process seems to have come to an end. Only minor changes were made in the 2003/04 budget[13].

Some principal trends in the statutory Customs duty rates published in the official tariff schedules -- there are no comprehensive estimates which systematically quantify the effects of exemptions[14] -- are given in Table 3.5. It can bee seen that the reduction program brought unweighted average Customs duties down from 41.7% to 20.4% in 2001/02 and to 17.3% in 2002/03. Like all the other tariff reduction programs in South Asia, Pakistan's was "top down" with reductions in the top normal rate pushing more and more tariff lines into lower rate categories or "slabs". However, the number of slabs was also reduced independently, notably from 14 to 6 between 1996/97 and 1997/98 and later on in 2001/02 with the abolition of the zero tariff slab, cutting the number of slabs to from 5 to just 4 at present.

Table 3.8 Pakistan Customs duties 1996/97-2002/03

Simple average rates	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03
All products	41.7	n.a.	n.a.	n.a.	24.8	20.4	17.3
Ag products	47.2	n.a.	n.a.	n.a.	28.0	21.8	19.6
Industrial products	40.8	n.a.	n.a.	n.a.	24.3	20.2	16.9
Normal maximum rate	65	45	40	35	35	30	25
No. of standard rates ("slabs")	14	6	6	5	5	4	4

Notes: Unweighted average Customs duties for 1996/97, 2000/01 and 2001/02 from WTO TPR report on Pakistan, 2002, Table 3.1. Averages for 2002/03 calculated from WITS database.. The averages are of statutory rates published in the Pakistan Customs Schedule and do not include specific tariffs. They also do not take account of exemptions and partial exemptions. Allowing for exemptions would reduce the average level and change the tariff structure, especially in the earlier years.

Despite the steady reduction of the top rates and the removal of the zero-duty slab, Customs duties in Pakistan are still quite dispersed (Table 3.9), although far less than they were in 1996/97 and before. In 2002/03 about 45% were either at 5% or 10% and almost 40% at 25%. In the 2002/03 budget, a fairly large number of duties were reduced from 20% to 10% and others (all raw materials and components of various kinds) from 10% to 5%. These changes would have partly offset the reduction in available effective protection resulting from the drop in the ceiling Customs duty from 30% to 25%. Even though as a result Customs duties in Pakistan still appear to be quite escalated, the present structure is much lower on average and appears to be much less distorting than it was during the 1980s and the first half of the 1990s.[15] The reduced number of slabs and the large numbers of rates within HS chapters that are identical have increased the transparency of the system and should have reduced the transaction costs of the business community and the administrative costs of the Customs administration.

[13] The unweighted average Customs duty in 2003-04 was 17.1% compared to 17.3% in 2002/03

[14] However there are a number of useful unpublished World Bank reports by Tom Maxwell which analyze Pakistan's tariff exemptions. (Maxwell, Tom. *Issues in Tariff Reform in Pakistan*. Mimeo draft, December 11, 1996; *Tariffs in Pakistan*. Mimeo draft, June 25, 2000. *Improving the Export Environment in Pakistan*. Mimeo draft, July 4, 2000).

[15] This is nicely illustrated in the 2002 WTO TPR report (p. 10).

Table 3.9

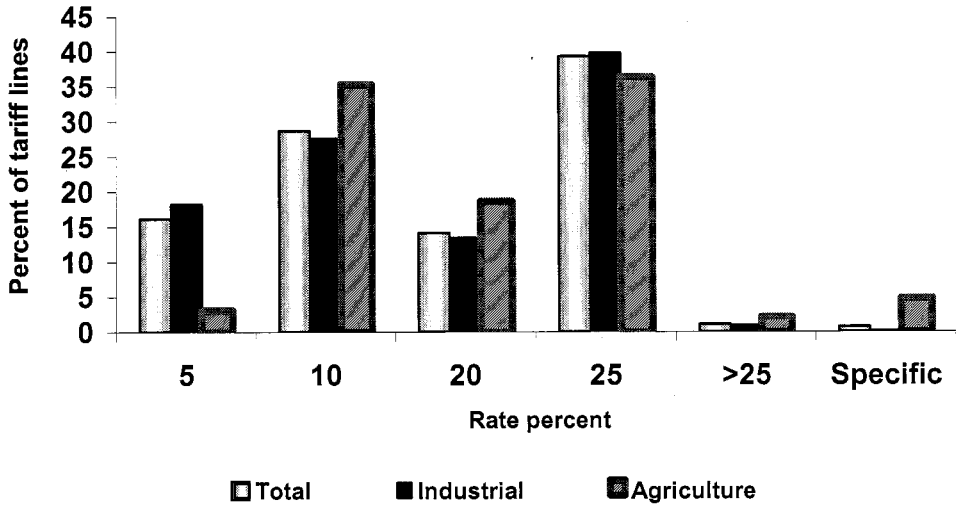
Pakistan 2002/03

Distribution of 6-digit tariff lines

Tariff %	Total	Industrial	Agriculture
5	16.2	18.2	3.0
10	28.6	27.6	35.2
20	14.1	13.4	18.6
25	39.3	39.8	36.3
>25	1.1	0.9	2.1
Specific	0.7	0.1	4.7
Average	17.3	16.9	19.6
No. of lines	6043	5219	823

Notes: The tariffs are the MFN Customs duty rates in force during fiscal 2002/2003. There were some minor changes only in the June 2003 budget. "Industrial"=HS Chs 25-97. "Agriculture" =HS Chs 1-24. This differs slightly from the definition of "agriculture" under the WTO Agreement on Agriculture. Averages are of ad-valorem tariffs only and exclude specific tariffs.

Fig 3. 4
Pakistan: Distribution of Customs duty rates 2002/03



Imports in Pakistan are subject to two principal taxes in addition to Customs duties: (1) sales tax, and (2) an income withholding tax. In addition a few products are subject to excise taxes. The tax base for the sales tax on imports is the (cif price + Customs duty). The tax base for the income withholding tax (WHT) is (cif price + Customs duty + sales tax). The general sales tax rate (on both imports and domestic sales) is 15%. The general income withholding tax rate is 6% for imports and 3.5% on the sales of

domestic taxpayers. When applied to imports at these normal rates, the total import tax rates for the four principle Customs duty rates ("slabs") in Pakistan, and one illustrative above- normal Customs duty, are:

Pakistan: Typical import taxes as percent of CIF price

Customs duty	Sales tax	Income withholding tax	Total import tax rate
5	15.8	7.2	28.0
10	16.5	7.6	34.1
20	18.0	8.3	46.3
25	18.8	8.6	52.4
100	30.0	13.8	143.8

Notes: Illustrated for the four principal normal Customs duty slabs and for one representative above-normal ad valorem tariff (100%).

The sales tax, income withholding tax and excise tax are also levied on the production of domestic goods and services, and in principle they should be neutral as regards protection of domestic industries. However, as applied in practice the income withholding tax is providing some extra protection over and above import duties, to a number of domestic industries, and the sales tax also appears to be protective in some cases. Excise taxes do not appear to have significant protective effects.

The income withholding tax is protective because the withholding tax rate is higher on imports than on domestic sales, and because it is "presumptive" i.e. it substitutes for taxes based on actual incomes or corporate profits and therefore acts as an indirect tax[16]. Estimating its protective effects is difficult and highly uncertain, because doing so requires estimating whether and by how much it increases the income tax paid by importers of a given product relative to income taxes paid by domestic producers of that product. This task is further complicated by various exemptions from the domestic withholding tax, in particular for manufacturers importing raw materials, components and equipment for their own use, and for producers of unprocessed agricultural products. Assuming gross importer profit margins of 20 percent, the extra protection is between 1.9 and 2.2 percent of cif prices, in the general case of imports subject to Pakistan's normal "tariff slabs" of 5, 10, 20 and 25 percent. The extra protection for unprocessed agricultural products is considerably more , ranging from about 4.9 percent to 8.6 percent of cif prices. But no extra protection is provided to local producers supplying intermediates or equipment to other producers who have the option of importing these products directly. There are no systematic estimates of the average protective incidence of this tax: very roughly, it is probably equivalent to (unweighted) average tariffs of about 1.5 percent (all tariff lines), one percent (non-agricultural tariff lines) and 3 percent (both processed and unprocessed agricultural tariff lines). These approximations have been given in Table 3.1, but are provisional and would need to be checked by more detailed analysis than has been undertaken for this report.

Since the 1980s the sales tax has been gradually converted into a VAT by extending its coverage and the number of stages in production and distribution that it covers. At present its coverage is comprehensive i.e. it covers importing, manufacturing, services, wholesaling and retailing. The present basic uniform sales tax rate is 15%[17]. Revenue from the sales tax has been growing rapidly and it is now by far the largest single revenue source (41% of total central government revenue in 2001/02). However,

[16] The withholding tax is presumed to be equal to the income tax that would be paid if it were based on income or profits in the normal way, and cannot be adjusted against the tax based on actual profits. This means, for example, that a person or firm must pay the income withholding tax even if there is no taxable income or a loss.

[17] There is a list of approximately 182 products which are taxed at 20% (S.R.O. 389(I)2001)

it is significant that most sales tax revenue (about 58 percent in 2001/02) comes from sales tax on imports.

A large number of products-mainly domestically produced agricultural products and foodstuffs-are exempt from sales tax. The exemptions are given in the Sixth Schedule to the Sales Tax Act. If sales taxes are exempt both when the item is imported and produced and traded locally, the sales tax provides no extra protection. But there may be extra protection if the sales tax is applied to a product when it is imported, but not when it is produced locally[18]. In this regard, the Pakistan system is distinctly non-transparent, and it is extremely difficult to assess which locally produced products may be receiving additional protection, and how much[19]. Some possible cases which need to be checked are powdered milk, fresh fruits and nuts (HS 08), some foodgrains, meat and fish preparations, and agricultural machinery including tractors. If this is correct, the total protective import duty rates on these products, including the protective effect of the Customs duties, sales taxes and the income withholding tax, appear to be more than the double the Customs duty rate alone e.g. in relation to cif prices, the total protective rate for fresh fruit would be approximately 52.4%, consisting of Customs duties (25%), sales tax (18.7%) and income withholding tax (8.7%). The sales tax exemptions need to be clarified so that it is possible for importers, businessmen and others to know in a transparent way which products are exempt, and for policymakers to know the resulting protection rates for domestic producers.

On average, *ad valorem* agricultural Customs duties are now a bit higher than industrial Customs duties, but there are more specific agricultural tariffs and proportionately more agricultural tariffs that exceed the 25% general maximum tariff. In addition, as noted above, extra protection from the income withholding tax and from sales tax exemptions seems to be much more marked for agricultural products than for non-agricultural products. For these reasons nominal protection rates available from protective import taxes are on average markedly higher for agriculture than for manufacturing and other sectors. On the other hand, manufacturing is generally considerably more input intensive then agriculture, and so the high proportion of low industrial Customs duties on raw materials and components most likely is creating on average higher available effective protection rates to value added in import substitution manufacturing, than the effective protection rates in agriculture.

The "tops down" reduction of tariffs that occurred between 1996/97 and 2002/03 seems to have reduced the role of tariff exemptions and concessions, for which demand is obviously greater when tariffs are high. In Pakistan these are announced in SROs (Statutory Rules and Orders), and past analyses have shown that the result has been to modify both the level and structure of tariffs very substantially, and to increase the effective protection of the firms that benefit from them. Most of these exemptions and concessions are for particular users, leading to many situations where the identical product pays different import duties depending on who imports it. The concessions often include exemptions or lower rates of the sales tax as well as Customs duties, but the value of this to importing firms in principle is small, since they then lose this as a their normal credit against sales taxes (in effect VAT) on their own sales. Most concessions benefit engineering and metal working firms, including firms in the auto industry. A majority are linked to local content (TRIMS) agreements under which the import duty reduction is given in return

[18] The exemption may not provide extra protection to domestic producers if subsequent purchasers of the domestic product are subject to sales tax. This is because by buying from the local supplier who is exempt from sales tax rather than importing, there is no input sales tax credit that can be deducted from the sales taxes they owe on their taxable sales. Therefore, with a choice between importing and buying locally, they would pay a lower price for the local good to offset the absence of the input credit.

[19] A principal reason for this opacity is that the Sixth Schedule of the Sales Tax Act does not define many of the exempted products in terms of their HS codes, and in many cases it is unclear whether the exemptions apply to domestically produced products only, or to both domestic products and imports. The published Customs Tariff Schedule provides for sales tax on imports of practically all products in the HS agriculture chapters (1-24), but despite this it seems that in practice many of these products are exempted from sales tax when they are imported. Another problem is that some products (vegetables and fruit) are exempt from sales tax only when they are not "bottled, canned or packaged".

for commitments to incorporate specified locally produced inputs or to meet local-content targets. Others are simply requests from using firms for lower tariffs that are granted if the particular input cannot be supplied by domestic producers.

In order to administer both the local-content schemes and the general provision for tariff concessions which are independent of any local content requirement, an elaborate apparatus was established under the Ministry of Industry and Production. Its Engineering Development Board (EDB) was made responsible for creating and updating a list of products produced in Pakistan which can contribute to local content requirements. A network of experts determines case-by-case whether the specifications, quality, and delivery conditions of particular local products are satisfactory, and if not satisfactory to decide whether applicant firms should receive a Customs duty exemption or concession if the product is imported. The considerable potential of this system for creating negotiating opportunities and delays and leading to inefficient economic decisions is apparent from its description. It has attracted the critical attention of analysts of Pakistan's trade policy regime, including in the past at least one World Bank-sponsored study[20].

The local content arrangements (generally known as "deletion" programmes in Pakistan) clearly breach the WTO TRIMs agreement, and under the TRIMs rules for developing countries, were supposed to have been phased out by December 31 1999. Following a number of WTO extensions, the non-auto engineering industry deletion programmes were phased out, some going in June 2002, others in December 2002, and the remainder in June 2003. An extension for the auto industry deletion programmes to December 31 2003 was obtained at the WTO, but as of April 2004 these programmes were still operating and a further extension until Dec 31 2006 had been requested[21]. With the important exception of the auto industry, both the phase-out of the general engineering and other TRIMs arrangements, and the big reduction of tariff rates that has occurred since 1986/87 are reported to have greatly reduced the interest of Pakistani firms in negotiating with the EDB and Customs to obtain tariff exemptions or concessions. It would be worth having a closer look at how these apparently efficiency-enhancing effects of the abandonment of TRIMS and lower tariffs have worked out.

Compared to the other South Asian countries, Pakistan has very few "tariff peaks" above the general maximum of 25%. However, one set of very high tariffs (with rates of 75%, 100%, 125%, and 150% for cars and vans, 90% for motorcycles, and 60% for trucks and light commercial vehicles) protects the auto assembly and component industry, and is part of the complex regulatory framework managed by the Engineering Development Board that gives tariff concessions on imported components in return for local content commitments. The other set of "tariff peaks" that protect a major industry are specific duties on edible oils (discussed in the chapter on agriculture). Apart from these, there are high tariffs on alcoholic drinks, but these appear to be for consumption control since there is no officially recognized domestic production. There are also specific duties on most petroleum products, but the *ad valorem* equivalents of these duties are not known.

In the past Pakistan used "regulatory duties" imposed after inquiries by the Tariff Commission on top of normal Customs duties to provide extra protection to particular local industries. Currently only a few regulatory duties are in force, and new duties are not being imposed[22]. One of the principal industries protected in this way was the steel industry, with regulatory duties on steel coils and steel pipes, but these duties appear to have been dropped by 2003/04. Customs duties on these and other steel products were at the general maximum rate of 25%.

[20] World Bank,....

[21] For information on the latest extension request, see WTO document G/C/W/487, dated 16 April,2004 on the WTO website.

[22] WTO, 2002. Pakistan TPR Report pp 32-33, and discussions at the Tariff Commission in February 2002.

The principal function of the Pakistan National Tariff Commission used to be managing inquiries, following industry requests for regulatory duties, and making recommendations to the government. Instead, during the past three years the Tariff Commission has helped prepare and geared up to commence administering a new anti-dumping law. For this it received technical assistance from a variety of international sources, including the WTO (rules division) EU, ADB (legal department)[23], the US International Trade Commission and the US Department of Commerce. The first anti-dumping case (on electrolytic tinplate from South Africa) was decided in November 2002, and there have been two others since then (on sorbitol imported from France and Indonesia) and on acetic acid from China (Taiwan)[24]. As in India, and greatly influenced by the Indian example, unless there is greater awareness of and resistance to the protection-increasing and rent-seeking potential of anti-dumping than appears to be the case in Pakistan at present, anti-dumping is likely become a major source of additional protection over and above prevailing tariffs. In Pakistan, as elsewhere, now that anti-dumping has been established and has an institutional home, reining it in, let alone removing it, will be extremely difficult in the face of domestic protectionist lobbies and its international legitimacy. As regards the latter, it seems that the advice received by the Tariff Commission was almost entirely from lawyers expert in the technical legalities of anti-dumping and that there was practically no advice on, or recognition of, its likely negative consequences for the liberalization of trade and trade-related policies in Pakistan.

Bangladesh[25]

During the first half of the 1990s Bangladesh cut its tariffs drastically, bringing the unweighted average protective rate (Customs duties plus para-tariffs-see discussion below) down from 73.6% in 1991/92 to 32% in 1995/96 (Tables 3.10, 3.11 and Figs 3.5, 3.6, 3.7 and 3.8). However, after 1995/96 this liberalizing impetus stalled, and during the following nine years tariffs declined only slightly. Average industrial tariffs came down modestly (by 5.1 percentage points from 31.9% to 25.4%) but the average protective rate for agriculture (including fisheries, livestock and processed foods)[26] remained practically unchanged (from 32.4% to 32.1%). Over all tariff lines the unweighted average protective rate declined by only 5.5 percentage points, from 32% to 26.5%. During this period many other developing countries were continuing to increase their integration with the world economy by cutting tariffs, so that, as noted previously (Table 3.4) in terms of average tariff levels, Bangladesh is now one of the most protected economies in the world. Using the WTO's benchmark of tariffs exceeding 15%, almost three-quarters of its tariffs are "international peaks" (Table 3.11). It also has by far the highest average tariffs in South Asia, except in agriculture where India's tariffs are even slightly higher than Bangladesh's. However, as has been emphasized previously, average tariffs are indicators of average *available* protection against import competition: actual domestic prices may not reflect these tariff protection levels, and if the average tariffs were weighted by production, the weighted averages could turn out to be higher or lower than the unweighted averages. As in both India and Pakistan, both these observations are especially relevant for Bangladesh's agriculture, where, in particular, rural production is dominated by rice which is generally priced at, or even below world prices, and for which protective tariffs are generally low (in 2003/04 they were 7.5%). These and other trade policy issues in agriculture are discussed in more detail in the chapter on agriculture in Volume II of this study.

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[23] The support from ADBs legal department is surprising considering that during these years (1999-2002) ADB was simultaneously supporting a major and successful program to liberalize Pakistan's trade regime. Depending on how it develops, anti-dumping could undermine many of these initiatives.

[24] Details of these cases are on the National Tariff Commission website <www.ntc.gov.pk>

[25] Analysis of tariffs, protection and revenue in this section reflects Bangladesh tariffs as of April 2004. Therefore, it precedes the tariff changes announced in the FY05 Budget on 10 June, 2004, which brought down the top CD rate to 25, moved to three-tier non-zero tariffs, and significantly scaled down supplementary duties.

[26] HS 1-24. This definition of "agriculture" differs somewhat from the WTO definition of the sectors covered by the Agreement on Agriculture, mainly by including fisheries and marine products (HS 03) and excluding hides and skins and various natural textile fibres such as jute, cotton and wool.

Table 3.10

Bangladesh 1991/92-2003/04: Unweighted Average Protective Import Duty Rates

	All tariff lines			Industrial tariff lines			Agriculture tariff lines		
	Customs duties	Para-tariffs	Total prot rate	Customs duties	Para-tariffs	Total prot rate	Customs duties	Para-tariffs	Total prot rate
1991/92	70.64	2.98	73.62	69.72	3.44	73.16	76.64	-0.01	76.63
1992/93	57.93	2.59	60.52	57.34	2.99	60.33	61.83	-0.03	61.80
1993/94	43.47	2.43	45.90	43.13	2.84	45.97	45.58	-0.17	45.41
1994/95	34.24	3.30	37.55	33.52	3.54	37.06	37.49	2.23	39.72
1995/96	28.70	3.26	31.96	28.40	3.47	31.87	30.07	2.28	32.36
1996/97	28.24	3.38	31.61	27.79	3.58	31.37	30.25	2.48	32.73
1997/98	27.27	5.88	33.15	26.80	5.98	32.78	29.42	5.42	34.83
1999/99	26.59	5.82	32.41	26.23	5.92	32.15	28.19	5.37	33.56
1999/2000	22.40	6.99	29.39	21.86	7.33	29.19	24.87	5.41	30.28
2000/01	21.10	7.43	28.54	20.39	7.84	28.23	24.53	5.46	30.00
2001/02	21.02	8.41	29.43	20.28	8.47	28.75	24.60	8.15	32.74
2002/03	19.91	6.51	26.42	19.08	6.74	25.82	23.85	5.44	29.29
2003/04	18.82	10.29	29.11	18.02	8.81	26.82	22.56	17.22	39.77

Fig 3.5
Bangladesh 1991/92-2003/04:All Tariff Lines, Unweighted Average Protective Import Duties

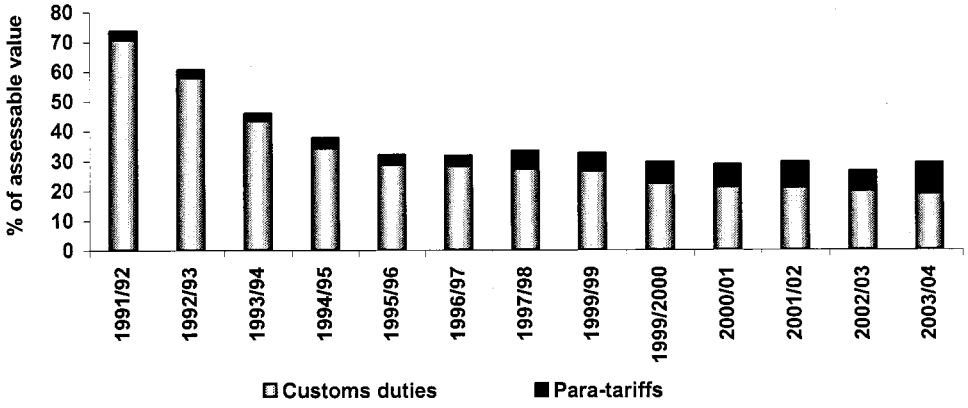


Fig 3.6
Bangladesh 1991/92-2003/04: Industrial Tariff Lines. Unweighted Average Protective Import Duties

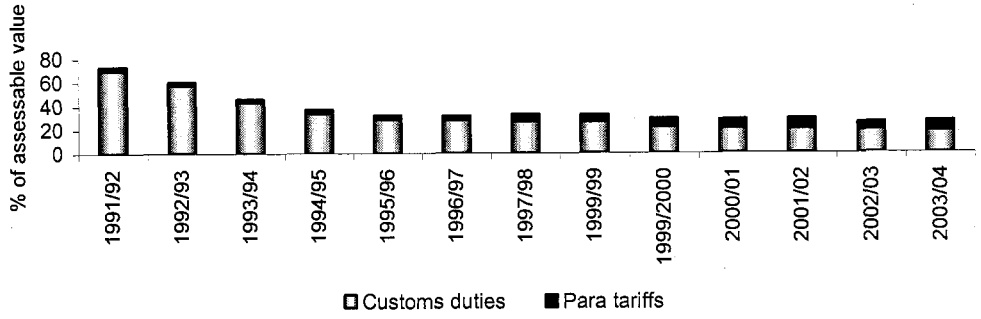


Fig 3. 7
Bangladesh 1991/92-2003/04: Agriculture Tariff Lines. Unweighted Average Protective Import Taxes

Table 3.11

Summary Indicators of MFN Tariffs in Bangladesh, 1991/92-2004/05

	1991/92	1995/96	2003/04	2004/05
Unwtd average Customs duties %, all tariff lines	70.64	28.70	18.82	16.31
Industrial (HS 25-97)	69.72	28.40	18.02	15.62
Agricultural etc (HS 01-24)	76.64	30.07	22.56	19.66
Unwtd total protection rate %, all tariff lines	73.62	31.96	29.11	26.50
Industrial (HS 25-97)	73.16	31.87	26.82	25.35
Agricultural etc (HS 01-24)	76.63	32.36	39.77	32.12
Standard deviation of total protection, all tariff lines	41.87	15.91	25.90	25.54
Industrial (HS 25-97)	42.61	16.14	24.48	25.56
Agricultural etc (HS 01-24)	36.55	14.82	29.43	24.71
Percentage & number of lines with international tariff peaks (total protection rate > 15%)	93.28 (6233)	86.06 (5810)	72.46 (4983)	70.05 (4698)
Average collection rate %, all import taxes, all lines	28.66	23.66	18.00	N/A
Average collection rates, all import taxes, all lines, excl. duty free export-related imports	37.41	31.77	25.53	N/A
WTO bindings: % of all tariff lines	0.0	13.2	13.2	
Average of bound rates	n.a.	188.3	188.3	
WTO bindings: % of industrial tariff lines	0.0	0.9	0.9	
Average of bound rates	n.a.	50	50	
WTO bindings: % of agricultural tariff lines	0.0	100	100	
Average of bound rates	n.a.	197.1	197.1	

Notes. The averages reported in this Table are for 6877 8-digit basic tariff lines. They do not include exemptions or concessional lower rates for specified uses or users of these products. However the tariff collection rates take account of these exemptions and concessions. The collection rates (import duty collected/value of imports) include VAT but not the advance income tax on imports (AIT).

As in the other South Asian countries, Bangladesh's early tariff reductions from the extremely high and in many cases prohibitive levels of the 1980s, were implemented by a "tops down" process in which maximum Customs duties were successively cut, thereby drastically reducing the number of Customs duty bands (or "slabs"). The top Customs duty rate came down from 350 % in 1991/92 to 50% in 1995/96, and the duty structure was simplified by reducing the number of Customs duty "slabs" from 17 to 6[27]. After 1995/96 the maximum Customs duty rate was reduced each year to 37.5% in 1999/2000, and subsequently to 32.5% in 2002/03, 30% in 2003/04, and 25% in 2004/05. There are now only three Customs duty slabs, or effectively four Customs duty slabs if zero is included viz, 25, 15, 7.5 and 0 percent. Because of these reductions, average Customs duties continued to decline after 1995/96, and by 2003/04 they were respectively about 10, 10 and 8 percentage points lower (for all tariff lines, industrial tariff lines, and agricultural, fisheries and livestock tariff lines) than they had been in 1995/96

However, Bangladesh also uses a number of other import taxes (currently four-hereafter collectively referred to as para-tariffs) which raise protection above the levels provided by Customs duties alone. These are a central and important feature of the import regime and are discussed in more detail below[28]. The average total extra protection provided by these para-tariffs is shown separately in Table

[27] For more details on Bangladesh's tariff reductions up to 1999/2000 see Annex Table A.1 in the November 1999 World Bank report on Bangladesh's trade policies (World Bank, 1999, November). The unweighted average tariffs given in the World Bank report are lower than the averages reported here because they include various exemptions and partial exemptions for particular uses or users of the imported products.

[28] Bangladesh's para-tariffs have been discussed in a number of earlier reports and papers, notably in the November 1999 World Bank study of Bangladesh's trade policies (World Bank, 1999, November), in the WTO TPR report on Bangladesh in 2000, and in Daly, Khan and Oshikawa (2001).

3.10 and in Figs 3.5, 3.6 and 3.7, and details of the average protective incidence of each of the individual para-tariffs since 1991/92, are given in Table 3.12. As is apparent from these statistics, in the early stages of the Customs duty reductions, the extra protection provided by the para-tariffs remained (on average) quite modest (about 3 to 3.5% of import prices) and the drastic reductions in Customs duties were accompanied by corresponding reductions in total protection rates. But since 1995/96, the total protective incidence of the para-tariffs has been going up, especially for agriculture where there was a sharp increase in 1997/98, and a really dramatic increase in 2003/04. Consequently, for all tariff lines, between 1995/96 and 2003/04, average Customs duties fell by 9.9 percentage points, but most of this reduction was offset by an increase in average para-tariffs of 7 percentage points. For industrial tariffs, Customs duties during these years went down by 10.4 percentage points, but about half of this reduction was offset by an increase in average para-tariffs of approximately 5 percentage points. In the case of agriculture, Customs duties were cut during the period by 7.6 percentage points, but this reduction was far outweighed by an increase in average para-tariffs of approximately 14.9 percentage points. In 2003/04, para-tariffs accounted for 35% of the average protection rate for all tariff lines, 33% of the protection rate for industrial products, and 43% of the average protection rate for agricultural, fisheries, livestock and processed food products.

The Bangladesh para-tariffs can be divided into two categories, general import taxes that are applied more or less across the board to all tariff lines, and selective import taxes that are applied to particular products only.

At present there is just one general para-tariff, the "Infrastructure Development Surcharge" (IDSC). It was introduced in 1997/98 at a rate of 2.5% , subsequently increased to 3.5% in 2002/03, and to 4% in 2003/04. The base for the IDSC is "assessable value", i.e. the cif price plus a 1% "landing fee", which is the same as the base for Customs duties. Even though in principle it is a general import tax applied to all imports, in 2003/04 210 tariff lines (about 3% of the total) were exempt. Until 2001/02, there was also an across-the-board "license fee" (LF) at 2.5% of assessable values. This was abolished in 2002/03. In addition to these taxes, imports are also subject to an "advance income tax" (AIT) at a general rate of 3% of assessable value: some products are exempt. Since the AIT is a payment towards the income taxes of the importer, and since most domestic producers are also subject to income taxes, in Bangladesh it is generally not considered to provide extra protection and (in contrast to Pakistan's advance income tax on imports) it has not been treated as a protective para-tariff in this study. However, like any other domestic tax also applied to imports, it could conceivably have protective effects if income taxes are exempt or not effectively collected from domestic producers of importable products.

Table 3.12

Bangladesh 1991/92-2003/04

Averages of Customs duties and para-tariff components of total protection rates

		Number of	General Protection			Selective Protection			Total
FY	Category	Tariff Lines	CD Rate	IDSC Rate	LF Rate	RD Rate	P-SD	P-VAT	Protection
91-92	Agricultural	882	76.64		2.50		-3.25	0.73	76.63
91-92	Non-Agricultural	5,800	69.72		2.50		-0.99	1.93	73.16
91-92	Total	6,682	70.64		2.50		-1.29	1.77	73.62
92-93	Agricultural	862	61.83		2.50		-3.16	0.63	61.80
92-93	Non-Agricultural	5,703	57.34		2.50		-0.80	1.29	60.33
92-93	Total	6,565	57.93		2.50		-1.11	1.20	60.52
93-94	Agricultural	859	45.58		2.50		-2.96	0.29	45.41
93-94	Non-Agricultural	5,436	43.13		2.50		-0.82	1.16	45.97
93-94	Total	6,295	43.47		2.50		-1.11	1.04	45.90
94-95	Agricultural	1,213	37.49		2.50		-0.32	0.05	39.72
94-95	Non-Agricultural	5,401	33.52		2.50		-0.15	1.19	37.06
94-95	Total	6,614	34.24		2.50		-0.18	0.98	37.55
95-96	Agricultural	1,223	30.07		2.50		-0.30	0.08	32.36
95-96	Non-Agricultural	5,528	28.40		2.50		-0.16	1.14	31.87
95-96	Total	6,751	28.70		2.50		-0.19	0.95	31.96
96-97	Agricultural	1,261	30.25		2.50		-0.31	0.29	32.73
96-97	Non-Agricultural	5,689	27.79		2.50		-0.02	1.10	31.37
96-97	Total	6,950	28.24		2.50		-0.07	0.95	31.61
97-98	Agricultural	1,261	29.42	2.49	2.50		0.25	0.18	34.83
97-98	Non-Agricultural	5,746	26.80	2.49	2.50		0.24	0.75	32.78
97-98	Total	7,007	27.27	2.49	2.50		0.24	0.65	33.15
98-99	Agricultural	1,276	28.19	2.46	2.50		0.24	0.17	33.56
98-99	Non-Agricultural	5,764	26.23	2.49	2.50		0.17	0.77	32.15
98-99	Total	7,040	26.59	2.48	2.50		0.18	0.66	32.41
99-00	Agricultural	1,253	24.87	2.47	2.50		0.27	0.17	30.28
99-00	Non-Agricultural	5,693	21.86	2.45	2.50		1.56	0.82	29.19
99-00	Total	6,946	22.40	2.46	2.50		1.33	0.70	29.39
00-01	Agricultural	1,159	24.53	2.48	2.50	0.07	0.28	0.14	30.00
00-01	Non-Agricultural	5,584	20.39	2.46	2.50	0.01	2.05	0.82	28.23
00-01	Total	6,743	21.10	2.46	2.50	0.02	1.75	0.70	28.54
01-02	Agricultural	1,164	24.60	2.48	2.50	2.64	0.35	0.18	32.74
01-02	Non-Agricultural	5,642	20.28	2.45	2.50	0.26	2.18	1.08	28.75
01-02	Total	6,806	21.02	2.46	2.50	0.67	1.86	0.92	29.43
02-03	Agricultural	1,213	23.85	3.42		0.05	1.84	0.13	29.29
02-03	Non-Agricultural	5,739	19.08	3.42		0.12	2.42	0.77	25.82
02-03	Total	6,952	19.91	3.42		0.11	2.32	0.66	26.42
03-04	Agricultural	1,214	22.56	3.67		5.65	2.82	5.08	39.77
03-04	Non-Agricultural	5,663	18.02	3.92		0.17	3.90	0.82	26.82
03-04	Total	6,877	18.82	3.88		1.14	3.71	1.57	29.11

The averages are of basic tariffs: they do not take account of exemptions or concessions for specified uses or users.
CD=Customs duty; IDSC=Infrastructure Development Surcharge; LF=License fee; RD=Regulatory duty; P-SD=Protective supplementary duty; P-VAT=Protective Value Added Tax; P-Total=Total protective rate

There are three selective para-tariffs which provide extra protection above the protection from Customs duties and the IDSC tax. These are "regulatory" duties, "supplementary" duties, and the use of the VAT to provide extra protection by exempting domestically produced products, or levying VAT on the production of specified products at lower rates than the VAT rate on imports. The way these para-tariffs operate and provide extra protection is complex and distinctly non-transparent, especially when more than one of these techniques is applied to a given product. In 2003/04 either singly or in combination, they were being applied to 1328 tariff lines (19.3% of the total-see Table 3.13). The number of tariff lines subject to them expanded very considerably in 2003/04:

	Number of tariff lines[29]		
	2002/03	2003/04	Increase
With regulatory duties	35	334	+299
With protective supplementary duties	356	691	+335
With protective VAT	442	727	+285

Almost all the regulatory duties and the protective supplementary duties (87% and 93% respectively) are being used to provide extra protection when the Customs duty is already at the maximum applied rate of 30% (Table 3.14). However, for reasons that are not immediately apparent, 31% of the protective VATs are being used when the Customs duty is below the maximum applied Customs duty rate. How each of these para-tariffs are applied and their protective effects are briefly described below.

Table 3.13

Bangladesh 2003/04: Distribution of tariff lines with extra protection provided by VAT exemptions, supplementary duties or regulatory duties

Extra Protection from	No of tariff lines	Percent of total lines
VAT only	372	5.41
SD only	389	5.66
RD only	145	2.11
VAT+SD	233	3.39
VAT+RD	122	1.77
SD+RD	67	0.97
Total	1328	19.31
No extra protection	5549	80.69
Total lines	6877	100.00

Notes: World Bank staff estimates from NBR database

[29] The total of these para-tariffs is less than the number shown in Table 3.11 owing to their use in combination e.g. extra protection for particular products from both supplementary duties and protective VAT.

Table 3.14

Bangladesh 2003/04: Distribution according to Customs duty rates of tariff lines with extra protection provided by non-general para-tariffs

CD rate %	VAT exemption		Supplementary duties		Regulatory duties	
30.0	432	59.42	644	93.47	290	86.83
22.5	126	17.33	33	4.79	31	9.28
15.0	99	13.62	8	1.16	8	2.40
7.5	58	7.98	4	0.58	0	0.00
0.0	12	1.65	0	0.00	5	1.50
	727	100.00	689	100.00	334	100.00

Notes: World Bank staff estimates from NBR database

Regulatory duties are applied to assessable values and so they in effect become an additional Customs duty. Even though they have been on the books for many years they were not used during the 1990s, but were reintroduced during 2000/01 (Table 3.12). In 2003/04 there were 5 different regulatory duty rates (5, 10, 15, 22.5 and 30 percent): 71 percent of the applied rates were at 30 percent. About two thirds of the regulatory duties were being used to provide a massive increase in protection to the domestic marine products industries (producers of fresh and processed fish, shrimp, and crustaceans covered by HS 03 of the tariff schedule). As a result, in 2003/04 most total protection rates for these industries went up from approximately 36% to either 64% (fresh products) or 88% (processed products). The other regulatory duties were providing extra protection for various producers of transport equipment and electrical and non-electrical machinery. There were no regulatory duties applied through the budget of 2004/05.

Supplementary duties (SDs) are applied to (assessable value + Customs duty), and so their protective effect increases with the Customs duty rate. In 2003/04 there were 691 tariff lines subject to SDs, and nine SD duty rates applied to imports (15, 25, 30, 40, 50, 60, and 75 percent). For a Customs duty rate of 30%, these supplementary duties are respectively equivalent to the following percentages of the duty free import price: 19.5, 32.5, 39, 52, 65, 78, and 97.5, percent. Approximately 35% of the SDs were on textiles (HS chapters 52, 54, 55, and 57) but the others were scattered over a heterogeneous set of products covered by 41 other HS chapters (out of the total of 97 chapters). In principle, SDs can also be imposed on domestically produced products, but in 2003/04 there was no domestic SDs for 94.5% of the 691 products subject to SDs when imported. Of the 38 products which were also subject to SDs if produced domestically, in only 18 cases (beer, various alcoholic drinks, and mobile phones) were the supplementary duties more or less neutral, in the sense of providing little or no extra protection for domestic production. For the other 20 products, the domestic SDs were markedly lower than the import SD rates, thus providing extra protection. Omitting the 18 products with approximately equivalent import and domestic SD rates, the average import SD rate applicable to the other 673 products was 30.1 %, but the average domestic SD rate on the same set of products was only 0.37%. Consequently, a major intention and effect of the supplementary duties is to provide extra protection. Otherwise, if the sole intention were to discourage consumption and/or raise revenue, the import and domestic SDs would be set at the same rate.

Value added tax (VAT) in principle is a trade-neutral tax, but in Bangladesh for at least 13 years in the past it has been systematically used to provide extra protection for selected import competing industries, by charging VAT on imports but exempting VAT on domestic production, or by imposing a

lower VAT rate on domestic production. In a complete and rigorously administered VAT system with VAT imposed and actually collected at all stages of production and on wholesale and retail distribution, exempting final stage manufacturers from VAT would not provide additional protection, because wholesalers and retailers buying from them would not obtain a VAT credit which they would be able to offset against the VAT liabilities on their own sales, whereas they would obtain this credit if they were to buy the same product from an importer. In Bangladesh, the scope of the VAT system does not effectively extend beyond the formal sector, so that exempting or imposing lower VAT rates on locally manufactured products which are not resold to other firms which are effectively subject to VAT, provides the manufacturers with extra protection. For example, imported textile fabrics are subject to the general 15% VAT, but the equivalent locally produced textile fabrics are subject to a domestic excise tax that works out to an equivalent VAT of 2.5%. In the domestic market, nearly all textile fabrics are sold to small-scale distributors and then to final consumers who mostly provide them to local tailors to cut and sew garments to order. None of these activities are effectively subject to VAT, so the low 2.5% VAT rate paid by the domestic fabric manufacturers provides them with a substantial extra advantage in competing against imported fabrics.

The general VAT rate in Bangladesh is 15%, and the base for the VAT on imports is (assessable value + customs duty + regulatory duty + supplementary duty). The effective VAT rate as a percentage of the assessable value therefore goes up with these other import duties. The base excludes the IDSC tax which is imposed on nearly all imports with few exceptions. The base for the domestic VAT of a manufacturer competing with imports is the ex-factory price, and so to estimate the protective effect of an exemption of the domestic VAT or a lower domestic VAT rate, it is necessary to first estimate this price. However, the domestic price includes the protection from the IDSC, so that (assuming manufacturers price up to the protection available to them) the base for the domestic VAT is a bit higher (by the protection from the 4% IDSC) than the base for the import VAT. Consequently, in the normal case when the import and the domestic VAT are the same (15%), there is small amount of negative protection (approximately -0.52% of border prices) from the VAT. Because of the interaction with Customs duties and the other protective import taxes, estimating the separate protective effect of the domestic VAT exemptions or lower domestic VAT rates, is extremely complex. In 2003/04, positive extra protection through the VAT was provided for 727 tariff lines (about 10.6% of the total). The VAT protection rates across all tariff lines were distributed as follows:

VAT protection rate as percent of assessable value	No. of tariff lines	% of total lines	Comments
17 rates from +12.2% to +32.2%	727	10.6	Average protective VAT rate 19.0%
0	897	13.0	Lines exempt from both import and domestic VAT (most also exempt from all other import duties and taxes)
-0.52%	5262	76.4	Import VAT = domestic VAT=15%
-16.5%	1	0.01	Domestic VAT but no import VAT (ayurvedic medicines etc)

Of the 727 tariff lines with positive VAT protection, for 56% the domestic VAT was zero, and for other 44% (all textile products) it was 2.5%. Products with positive VAT protection were in 31 of the 97 HS chapters, but most were textiles and agricultural, livestock and fisheries products. In 2003/04, a large number of domestic VAT exemptions were used to further increase the extra protection for the marine products industries (HS 03) that resulted from the imposition of the regulatory duties discussed previously. Other primary and processed food products with extensive VAT protection include meats (HS 02), dairy products (HS 04), vegetables and pulses (HS 07), spices (HS 09) and some cereals (HS

07). Of the products which received extra protection from VAT exemptions, about a third also received extra protection from supplementary duties, and 17 percent from regulatory duties. For the rest (just over half) the VAT exemptions were the only source of additional protection over the "normal" protection from Customs duties and the IDSC tax.

	Industries with positive VAT protection	No of tariff lines	Percent of total
HS 2-24	Agriculture, livestock, fisheries	307	42.3
HS 50-58	Textiles	360	49.5
HS 84	Machinery	39	5.4
10 other HS chapters	Various	20	2.8
	TOTAL	727	100.0

Of more concern than the effect of the selective para-tariffs on the average level of tariffs, is the fact that almost without exception they are invoked to give extra protection to local industries which are already benefiting from the maximum general protection rate of 34% i.e. the maximum Customs duty rate 30%, plus the IDSC tax (4%). They therefore bring up the general level of available tariff protection, not by small increases in a large number of tariffs, but by creating a set of high-to-very-high protective tariffs benefiting local industries which lobby for them. They are also distinctly non-transparent and complex. Some idea of their complexity is apparent from the descriptions of how they operate and the formulas for calculating their protective effects given in the Annex to Volume I of this study.

Table 3.15 gives some examples of the extra protection provided by para-tariffs and the resulting total protection rates. These are just a relatively small proportion of the 1328 products to which selective para-tariffs were being applied in 2003/04. The following points are worth noting:

- With a few exceptions (e.g. cement, iron and steel pipes) most of the products in this sample are import- substitution light consumer goods
- However, very high protection in the domestic market is also being provided to some of Bangladesh's principal exports e.g. cotton shirts, cotton trousers and cotton knitted T-shirts (total protection rate 85.48%), various seafood products (64% or 88%), sports footwear (52.98%), other footwear (65.98%).
- Total protection rates for the many of the industries protected by selective para-tariffs are in a range of from 50% to well over 100%. These levels are about the same or not far below prevailing tariff levels during the 1980s, before the Customs duty reductions of the early 1990s.
- For some products just one selective para-tariff is being used, but for others two in combination e.g. supplementary duties combined with protective VAT in the case of dairy products, sugar, and textile fabrics. The reasons for the use of particular instruments or combinations of instruments are obscure.

Table 3.15 also compares the total protection rates of these 55 product groups and products with their total protection rates in 1997/98. It is apparent that for industries producing these products, there was a massive increase in the tariff protection during these six years. The simple average protection rate for this sample of products went up by approximately 24 percentage points, from 51% to 75%. For 50 of the 55 products, protection went up over the period, in most cases very substantially e.g. processed seafood from 35% to 88%, milk powder from 47% to 62%, sugar from 47% to 85%, sweet biscuits from 47% to 131%, cement from 25% to 66%, soaps and detergents from 61% to 98%, plastic tableware from 51% to 91%, textile fabrics from 65% to 72%, glass and glass products from 47% to 85%. For the five products for which total protection rates declined, the reduction was minimal and from already high levels e.g. the salt protection rate fell from 150.8% to 143.2%, and the protection rate for after shave preparations fell from 64.6% to 54.6%.

Table 3.15

Bangladesh 2003/04: some examples of the extra protection provided by para-tariffs and comparisons with total protection rates in 1997/98

HS code	Product or product group	Protection rate % 2003/04						1997/98	Increase
		CD	IDSC	RD	SD	VAT	Total	Total	
0302	Fish, shrimp etc fresh	30	4	30	0	0	64.00	35.00	29.00
0302	Fish, shrimp etc processed	30	4	30	0	24	88.00	35.00	53.00
0402	Milk Powder	30	4	0	28.45	-0.52	61.93	47.17	14.76
0405-0406	Dairy Products	30	4	0	32.5	24.38	90.88	68.88	22.01
0805, 0806, 0808	Fruits:oranges, grapes, apples	30	4	0	52	0	86.00	47.50	38.50
0906-0909	Various spices	30	4	0	32.5	0	66.50	46.92	19.58
1701	Cane sugar	30	4	0	39	25.35	98.35	34.67	63.68
1704, 1806	Sugar confectionery	30	4	0	52	-0.52	85.48	47.17	38.31
1905	Bakery Products	30	4	0	97.5	-0.52	130.98	47.17	83.81
2007,2009 & 2103	Food Preps (Juice, Jam, Jelly, etc)	30	4	0	52	-0.52	85.48	47.17	38.31
220210	Soft drinks	30	4	0	35.14	-0.52	68.62	46.01	22.61
2501	Salt	30	4	0	78	31.2	143.20	150.81	-7.61
25232910	Portland Cement	30	4	0	32.5	-0.52	65.98	25.42	40.56
3208-3210	Paint & Varnish	30	4	0	32.5	-0.52	65.98	47.17	18.81
33,033,307	Perfumes	30	4	0	65	-0.52	98.48	68.55	29.93
3304-3305	Cosmetics	30	4	0	31.92	-0.52	65.40	64.62	0.78
3305	Shampoos	30	4	0	31.92	-0.52	65.40	64.62	0.78
3306	Toothpaste	30	4	0	65	-0.52	98.48	47.17	51.31
3307	After Shave preparation	30	4	0	25.3	-0.52	58.78	64.62	-5.84
3401	Soap & detergent	30	4	0	65	-0.52	98.48	61.42	37.06
3605	Safety Matches	30	4	0	19.5	-0.52	52.98	54.30	-1.32
3919-3921	Sheet Polythene	30	4	0	19.5	-0.52	52.98	47.17	5.81
3922	Plastic Sanitary-ware	30	4	0	32.5	-0.52	65.98	47.17	18.81
3924	Plastic Table & Kitchenware	30	4	0	32.5	24.38	90.88	54.63	36.26
4410-4412	Ply wood & particle board	30	4	0	19.5	-0.52	52.98	47.17	5.81
5208-5212,5407-5408 & 5512-5516	Textile Fabrics	30	4	0	19.5	18.13	71.63	64.82	6.81

5701-5705	Jute Carpet	30	4	0	19.5	22.43	75.93	47.17	28.76
5701-5705	Other Carpet	30	4	0	19.5	-0.52	52.98	47.17	5.81
610910, 620342, 620520	Cotton shirts, trousers & T-shirts	30	4	0	52	-0.52	85.48	47.17	38.31
6302	Cotton sheets	30	4	0	52	-0.52	85.48	47.17	38.31
6402-6404	Sports Footwear	30	4	0	19.5	-0.52	52.98	54.30	-1.32
6402-6405	Other Footwear	30	4	0	32.5	-0.52	65.98	54.30	11.68
6802	Ceramic Tiles: Other	30	4	0	27.8	-0.52	61.29	47.17	14.12
6904-6906	Ceramic Bricks, Roofing Tiles etc.	30	4	0	19.5	-0.52	52.98	47.17	5.81
6907-6908	Ceramic Tiles: Glazed/Unglazed	30	4	0	21.09	-0.52	54.57	47.17	7.40
6910	Ceramic Sanitary ware	30	4	0	55.55	-0.52	89.03	47.17	41.86
6911-6912	Ceramic Tableware & Kitchenware	30	4	0	65	-0.52	98.48	47.17	51.31
7003-7005, 7009,7013	Glass & Glass Products	30	4	0	52	-0.52	85.48	47.17	38.31
7304, 7306	Iron & Steel Pipe: Other	30	4	0	19.5	-0.52	52.98	47.17	5.81
7306	Iron & Steel Pipe: ERW pipe	30	4	0	52	-0.52	85.48	47.17	38.31
7324, 7418	Iron, Steel & Copper Sanitary-ware	30	4	0	52	-0.52	85.48	47.17	38.31
821210	Razors	30	4	0	19.5	-0.52	52.98	47.17	5.81
8301	Locks	30	4	0	19.5	-0.52	52.98	47.17	5.81
8414	Electric Fan	30	4	0	32.5	-0.52	65.98	47.17	18.81
85061020	Dry Cell Battery	30	4	0	52	-0.52	85.48	47.17	38.31
850710	Lead acid Battery	30	4	0	52	-0.52	85.48	47.17	38.31
8527	Radio & Cassette player	30	4	5	20.25	-0.52	58.73	46.98	11.75
85281290	Colour TV	30	4	0	20.25	-0.52	53.73	47.07	6.66
853929	Light bulbs	30	4	0	32.5	-0.52	65.98	54.30	11.68
8539	Fluorescent lamps	30	4	0	19.5	-0.52	52.98	54.30	-1.32
85441920	Electric cables: Co-axial cable	30	4	0	32.5	-0.52	65.98	47.17	18.81
8544	Electric cables: Other	30	4	0	52	-0.52	85.48	47.17	38.31
8712	Bicycle & other Cycle	30	4	0	52	-0.52	85.48	34.67	50.81
9403	Furniture	30	4	0	19.5	-0.52	52.98	47.17	5.81
9501-9503	Toys	30	4	0	52	-0.52	85.48	47.17	38.31
Averages of the 55 products and products groups		**30.00**	**4.00**	**1.18**	**36.85**	**2.66**	**74.69**	**50.84**	**23.86**

As well as creating very high protection rates for a wide range of domestic industries, the para-tariffs greatly reduce the ability of countries involved in preferential arrangements with Bangladesh (e.g. under SAPTA, the Bangkok Agreement or other preferential agreements) to benefit from preferences granted by Bangladesh (which are very small in any case). This is because the preferences generally do not apply to the para-tariffs, with the result that the preferential total protection rates may be prohibitively high, and because, when regulatory duties are used[30], the para-tariffs can greatly reduce the effective proportional margin of preference. For example, for fresh apples and apple juice, Bangladesh's preferential Customs duty for Bhutan is 15%, versus a general MFN Customs duty of 30%. However, after the IDSC tax and a 40% supplementary duty, the total protection rates on imported apples and apple juice from Bhutan (under a bilateral agreement) are 65% versus 86% from non-preferential sources. Preferential tariffs at this or similar very high levels may be prohibitive, and even if imports are feasible the resulting price preferences are very small or minimal. For example, the price preferences for apples from Bhutan and Nepal (under SAPTA) versus apples subject to the normal MFN Customs duties, are respectively only about 12% and 3.4% respectively, and the preferential total protection rate on frozen fish from Nepal, Bhutan and Maldives (under SAPTA) is 84.6%, versus the MFN total protection rate of 88%.

There is evidence that Bangladesh's initial tariff reforms up to the mid-1990s considerably reduced the potential for economic inefficiency in the form of high effective protection rates in import substitution industries, large incentive differences between industries, and overall high anti-export bias. According to the Bangladesh Tariff Commission,[31] for the domestic production of 40 sectors producing tradable goods, the average effective protection rate made available by tariffs fell from 75.7 % in 1992/93 to 33.3% in 1995/96, and the standard deviation of EPRs among the 40 sectors fell from 84.4% to 25.7%. After 1995/96 until the last estimates reported for 1999/2000, the average and standard deviation of the EPRs of the 40 sectors continued to fall, but at a much slower rate. Since then there are many indications that strong and effective resistance has developed to the compression of processing margins that is the intended and normally expected consequence of the kind of "tops down" tariff reduction program that has been implemented in Bangladesh:

- In budget speeches, Ministers of Finance have frequently stated that in setting import tariffs, the government is following a principle in which tariffs are escalated according to the degree of processing. For example, the 2002/03 budget speech stated that Customs duties were to be set as follows: "basic raw materials" 7.5%; "intermediate raw materials not produced in the country" 15%; "semi finished and locally manufactured intermediate goods" 22.5%; and "manufactured goods" 32.5%.[32]
- As already discussed, para-tariffs are being routinely applied with increasing frequency to raise protection for the outputs of many local industries to levels which are far above the maximum Customs duty rates. Many of these protection rates are now at, or not far below pre-reform levels. The establishment or expansion of new industries (e.g. cement) is also being encouraged by high para-tariff protection of their outputs
- At the same time, processing margins for local industries are being widened by cutting tariffs for raw materials, other intermediate inputs, and for machinery and equipment, when they are not already being produced domestically. This has included reducing tariffs on a wide range of raw materials and intermediates to zero. For example, Customs duties and all other import taxes

[30] Normal preferences related to Customs duties indirectly also reduce supplementary duties and protective VAT, since the bases for supplementary duties and VAT include Customs duties. Hence, when the para-tariffs used are supplementary duties and/or protective VAT, the proportional margin of preference is only slightly less than the Customs duty preference. However, the proportional preferential margin is reduced when there are regulatory duties, since that is applied directly to the import price (assessable value) and is not indirectly reduced by the preferences.

[31] Reported in World Bank (1999, November), Annex 1.

[32] Budget speech, 2002/03. Second part, Fiscal Measures, pp 56-57.

(including VAT) are zero for many inputs (animal feed, seeds, bulbs and roots, live poultry and live animals, fertilizers) used in the livestock, fisheries and agricultural sectors, and for a variety of steel and other metals and machines used in manufacturing.

- Alongside these general reductions of tariffs on intermediate inputs, many "end-user" concessions are granted by which specified materials, components or machines can be imported at lower (sometimes zero) Customs duty rates than the general rate, when they are used to produce specified products, or by specified firms or organizations. There are also "end user" concessions that exempt imports from VAT. These concessions have a long history in Bangladesh: they are the equivalent of the exemptions and partial exemptions that are also a feature of the tariff regimes in India and Pakistan. However, in Bangladesh they have been codified and given separate tariff lines in the tariff schedule, and in contrast to these countries it is possible to quantify them without undertaking a major separate research effort. Some indication of their importance can be seen in Fig 3.8, which shows that for the industrial sectors (HS 25-97) unweighted average industrial total protective import duty rates are considerably lower after including the end-user concessions. However, this does not mean that average tariff protection to existing industries is lower than previously indicated: on the contrary, the end user concessions increase the effective protection to the processing margins of the established industries which benefit from them, even though at the same time they reduce the protection to the outputs of potential producers of the products subject to the concessions.

Fig 3.8
Bangladesh 1991/92: Effects of end-user concessions on average industrial tariffs

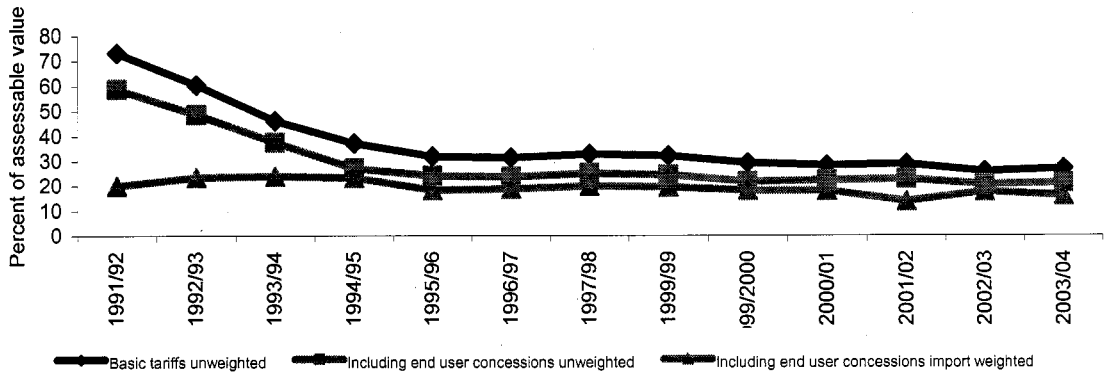
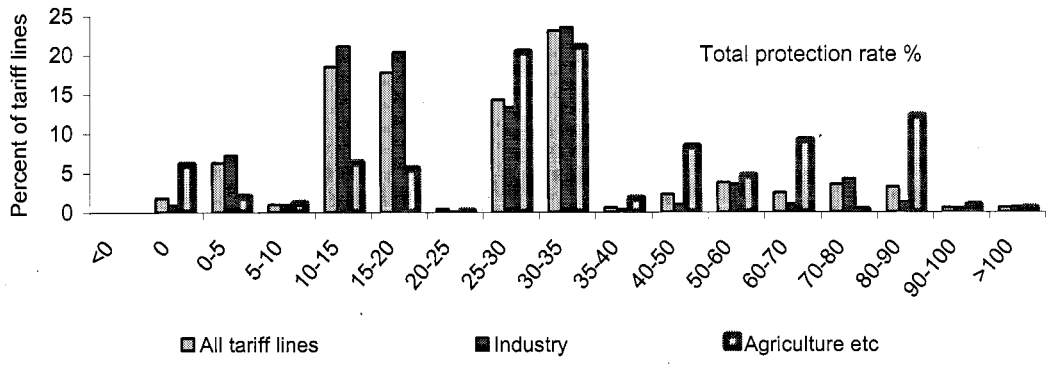


Fig 3.9
Bangladesh 2003/04: Distribution of total protection rates



Some indication of the effects of the trends and pressures described above can be seen from the very wide distribution of total protection rates in 2003/04 (Fig 3.9), with 86% of tariff lines below 34%, and 16% exceeding 34 percent. In addition (Table 3.11), whereas the variability of protective tariffs (as indicated by the standard deviation) fell considerably between 1991/92 and 1995/96, since then has increased quite sharply. *According to this indicator, in 2003/04 the tariff structure is considerably more distortive than it was in 1995/96.* Some of this change is a consequence of the increasing differences between protection rates of products subject to selective para-tariffs and products subject only to Customs duties and the IDSC tax, and another part to increases in the gap between tariffs protecting outputs, and tariffs affecting the cost of intermediate inputs and machinery. That the latter gap is substantial, is apparent from Table 3.16, which shows that in 2003/04 average protective tariffs on final consumer goods were markedly higher (about double) than average protective tariffs on basic raw materials and intermediate products. However, the tariff escalation between raw materials and intermediates is much less marked. This suggests that pressures to keep intermediate product tariffs down in the interests of final consumer good producers, have squeezed the processing margins of actual or potential producers of intermediate goods. The principal impact of this seems to be on industrial machinery when allowance is made for end-user concessions, since the average protective machinery tariff (12.23%) in that case is lower than the average protective tariffs for raw materials and intermediate products. Further study and analysis would be needed to obtain a clearer picture, but it seems highly likely that one by-product of the concerted effort to reduce the costs of import substitution consumer goods industries, has reduced the relative incentives for actual or potential producers of intermediate materials, components, and machines[33].

Table 3.16
Bangladesh 2003/04: Indicators of Tariff Escalation

	Tariff lines without end-user concessions		Tariff lines including end-user concessions	
	No of tariff lines	Average total protection rate	No of tariff lines	Average total protection rate
Basic raw materials	445	16.23	467	16.11
Intermediate products	2398	22.53	3265	19.76
Machinery and equipment	1103	19.22	2240	12.23
Final consumer goods	2931	40.16	3219	37.22

Notes: The end user concessions are entered in the tariff schedule as separate tariff lines. They do not include baggage imports and concessions for duty free imports of inputs used by exporters (principally imports in bond under back-to-back L/Cs and imports by firms in export processing zones).

Table 3.16 indicates the existence of tariff escalation on average, but the averages include protective tariffs for many products that are not being produced in Bangladesh. As in other countries, the gaps between the output and input tariffs of products that are actually in production will typically be greater than the average gaps considering all tariff lines, since there is an obvious motive for firms to lobby for increases in output tariffs that protect them against import competition, and for reductions in the tariffs that affect the costs of their inputs. This is certainly the case in Bangladesh: some examples of the escalation of total protection rates along some typical processing chains are illustrated in Table 3.17. In these examples, the escalation (and consequent high effective protection rates for the manufacturing processes) is made possible by the apparently minimal resistance on the part of the government to

[33] It is important to recognize that what matters are the relative incentives made available by the tariff structure, not their absolute level. The main problem with the apparently low or negative EPRs for potential intermediate good and machinery producers is not that they are low or negative, but that they are low relative to apparently very high EPRs for other industries.

suggestions and pressures to impose para-tariffs to protect the outputs, and to pressures to either cut input tariffs or to create special end-user concessional tariffs.

Table 3.17

Bangladesh tariffs 2003/04. Some examples of tariff escalation along processing chains: total protective rates % for principal material inputs and final products

		Flour	19.00					Plastic		Plastic	
Copra	26.5	Sugar	98.35	Clinker	33.48	Cotton	0	materials	18.48	materials	18.48
Crude coconut oil	25.98	Sweet biscuits etc	130.98	Grey portland cement	65.98	Cotton carded or combed	12	Plastic bathware	65.98	Plastic tableware	90.88
Refined coconut oil	65.98					Cotton yarn	32.93				
						Cotton fabrics >85%	71.63	Note: plastic materials include PVC, polystyrene, polyethylene, polypropylene, ABS copolymers, PVA etc in all forms (granular, powder etc)			
						Cotton shirts M&B	85.48				

Recent estimates of effective protection rates for manufacturing industries available from Bangladesh's tariffs in 2002/03 indicate very large continuing distortions and economic inefficiencies. The average EPR of 33 sectors with no exports or exporting less than half their output was 82.3%, compared with an average EPR of six export oriented sectors (shrimp, other fish, tanning and leather finishing, jute textiles, mill cloth and ready made garments) of -1.5%. EPRs of the import substitution industries ranged from -37% (pulses) to 538% (cosmetics and toiletries), and 13 of the 33 import substitution industries had EPRs exceeding 100%. It is highly likely that the increases in para-tariffs that occurred in 2003/04 will have further increased the general level of the processing margins and effective protection rates of import substitution industries made available by tariffs, and further increased both the dispersion of EPRs among import competing firms, and the very large excess of the incentives to produce for the domestic market over the incentives to export[34].

Bangladesh has bound only 50 (about 0.9%) of its industrial tariffs at the WTO. The Customs duties on these are bound at 50%, and "other duties and charges" (presumably meaning the para-tariffs discussed above, other than VAT and possibly supplementary duties) at 30%. All the rest, both Customs duties and para-tariffs, are unbound. Under the Agreement on Agriculture, it was required to bind all its agricultural tariffs, but nearly all of these (92%) were bound at the prohibitive level of 200%, plus "other duties and charges" bindings of 30%. Consequently, with only a very few exceptions, there is no formal external WTO-enforceable upper limit on Bangladesh's tariffs. It is highly unlikely that effectively not binding its tariffs will provide Bangladesh with leverage in future tariff negotiations, whether with the rest of the world at the WTO, or in regional trade negotiations. The reluctance to do so seems to reflect a desire to retain unlimited flexibility to increase tariffs whenever it is bureaucratically or politically opportune. This is a continuing issue for Bangladesh at the WTO, where other countries have regularly complained about the uncertainty this creates for their exporters and for Bangladesh importers[35]. In 2000, legal statutory Customs duty rates were brought down close to the levels of applied Customs duty rates, and this to some extent constrains the possibility of large reversals of Customs duty reductions, since

[34] World Bank staff estimates. The estimates use 1998 firm level survey data and unweighted 2002/03 average tariffs for outputs and inputs. For exports, it is assumed that 80% of the tariffs on imported inputs are exempted or rebated through drawback.

[35] This point is made in the 2000 WTO TPR report on Bangladesh (pp 38-39) . In the discussions on the report in May 2000 (see WTO document WT/TPR/M/68), the Bangladesh representative said that there were no plans to expand the number of bindings or to reduce their levels, but gave no reasons.

amendments to the statute need to be approved by Parliament. However, there is no effective constraint on the levels of the para-tariffs, which is why they have been become the method of choice for selective tariff increases in response to lobbying pressures. For this reason, the para-tariffs have also become a separate ongoing issue for Bangladesh at the WTO, since, as implemented, except for the regulatory duties, they are inconsistent with basic GATT rules[36].

Customs valuation has been and remains an issue in Bangladesh. Before 2000, lists of fixed tariff values, pre-shipment inspection (PSI) and actual invoices all had a role in determining the basis for Customs duties. The list of fixed tariff values was abolished in February 2000 and Bangladesh moved to the WTO transactions value system supported by mandatory PSI[37]. This has been accompanied by major efforts to computerize and improve Customs administration[38]. Despite these reforms, there is evidence that discretionary valuation practices, under-invoicing, and unpredictable transaction costs have continued, especially in the land border trade with India. The very high protective rates on a wide range of importable products, and the extreme complexity and general lack of transparency of the tariff system are not conducive to effective institutional reform of the Customs administration or of the other government ministries and agencies involved with trade policies.

To summarize this discussion of Bangladesh's tariff policies, although reductions in the top Customs duty rate and of average Customs duties since the mid 1990s give the impression of continuing import liberalization, the expanding use of selective para-tariffs and "end-user" concessions for inputs and machinery have markedly increased rather than reduced the distortionary potential of the tariff system. In various ways these changes have maintained or restored well known inefficiencies that the trade liberalization programs of the late 1980s and early 1990s were intended to remove or diminish. In particular:

- Very high protection of selected import substitution industries has the potential to remove or diminish the discipline of import competition and to support high cost production that is not viable in the long run
- Very high protection for their sales in the domestic market is being given to major export industries such as ready made garments, ceramics and seafood, largely precluding the possibility of economically efficient intra-industry trade in these sectors and making it more attractive for these industries to supply domestic niche markets rather than diversifying their product lines in export markets

[36] The use of VAT as a protective device is inconsistent with the national treatment principle (GATT Article III (1)),which requires that internal taxes "not be applied to imported or domestic products so as to afford protection to domestic production". In addition, supplementary duties protecting some agricultural, fisheries and livestock products exceed the 30% binding of "other duties and charges". In the May 1990 consultations on the WTO TPR report, Bangladesh's written responses to questions from other GATT members stated that bringing the supplementary duty into conformity with Article III was "being examined" (p.27), but in contradiction to this and incorrectly it was also stated that both the VAT and the supplementary duties "are imposed on both imports and domestic products and hence are trade-neutral" (p.33). The IDSC and the erstwhile license fee appear to be inconsistent with Article VIII which requires that fees and charges on imports other than Customs duties should be "limited in amount to the approximate costs of services provided, and ...not represent and indirect protection to domestic products". However, insofar as they are considered to be Customs duties, regulatory duties are probably GATT-legal, since imposing them is just another way of increasing Customs duties. If this is correct, all questions concerning the GATT-legality of the para-tariffs could be by-passed, by simply replacing them with regulatory duties. Regulatory duties could then be freely moved up and down subject only to the few industrial products with bindings, and the very high bindings of almost all the agricultural tariff lines.

[37] For a discussion of Customs administration and valuation issues including PSI up to 2000, see the 2000 WTO TPR report on Bangladesh, pp 34-37.

[38] Customs administration and other trade policy reforms have been supported by the World Bank and other aid agencies. See World Bank (1999, May)

- Since effective incentives for exports are generally about zero or negative, the increasing nominal and effective protection rates for import substitution products are increasing anti-export bias and making it more profitable to invest and produce for the domestic market rather than for export.
- Many of the very high protection rates are highly regressive with a disproportionate impact on low income consumers: for example, milk powder, dairy products, sugar, salt, sugar confectionery, sweet biscuits, cement[39], soap and detergents, textile fabrics, cotton shirts and trousers, dry cell batteries, bicycles, furniture. Ex-factory prices for these products would exceed world prices by 60% to more than 100% if local firms were to fully price up to the protection available to them from these tariffs (see Table 3.15). This should be a major concern for poverty reduction programs.
- In the process of ratcheting up protection for selected industries, tariff policies have discriminated heavily against the domestic production of products that have not been favored, especially intermediate materials and components, and machines. This is an outcome of reductions in raw material and intermediate products tariffs, the use of "end-user" concessions, and more generally from much lower incentives for these sectors than for the favored firms and industries.
- The many high protection rates make any serious negotiation on regional preferential trade (e.g. under SAPTA, SAFTA, of the suggested bilateral free trade agreement with India) highly problematic, because of the potential for large scale trade diversion and the consequent pressures to put these industries on an extensive "sensitive list".
- The tariff system remains distinctly non-transparent, creating difficulties and uncertainties for everyone involved in the system. For example, there is no easily available up-to-date published tariff schedule that includes all the para-tariffs, which would enable exporters to Bangladesh, importers or potential investors to identify the tariffs and protection rates that apply to the products that interest them. This in turn puts a premium on information and advice from insiders such as Customs agents and officials.
- The very high protection rates resulting from the para-tariffs, and the extreme complexity of the system, create obvious incentives for both "technical" smuggling" involving misdeclarations, under-invoicing and corruption at Customs, and reinforce "traditional" smuggling which by-passes Customs posts at land borders. This runs counter to longstanding efforts to automate and streamline the Customs administration system. In particular, both forms of smuggling are a major concern for the land border trade with India.

Sri Lanka

After its 1977 reform program, Sri Lankan tariffs were already much lower during the 1980s than tariffs in the other South Asian countries (Fig 3.1). During the 1990s there were further reductions in Customs duties and by 1999 the structure of protective tariffs had been considerably simplified. This included the abolition of Customs duties on textile fabrics and garments in 1997, so that since then the textile industry (as distinct from the garment industry) has been operating under free trade conditions. Since early 2001, however, there has been much churning and some backtracking from this earlier import liberalization:

- Introduction of a surcharge on Customs duties in February 2001. This was initially 40% of the Customs duty (e.g. a 10% duty was increased to 14% and a 25% Customs duty became 35%). In November 2002 the surcharge rate was reduced to 20% , and in January 2004 to 10%.
- In October 2001, reductions in the Customs duties on many raw materials (mostly not produced in Sri Lanka) from 10% to zero. While this reduced the unweighted average of Customs duties in

[39] A recent study of the cement industry indicates that domestic prices actually exceed world prices by the about the same margin as the cement tariff i.e. by about 66%.

the industrial sector, it increased the effective protection of import substitution industries which use the raw materials[40].

- In May 2002, the introduction of a "Ports and Airports Levy" (PAL) at 1% of cif prices.
- Across-the-board increases in most Customs duties in January 2004, especially for agricultural products (Fig 3.)[41].
- The increasing use of specific duties, principally to protect a number of domestic agricultural industries.

A "Cess" (introduced in 1981 to fund the Export Development Board) equivalent to 10% of Customs duties which are equal to or greater than 45% has also been continued. By comparison with 1999, it seems that the combined effect of these changes has increased the protectiveness of the system, but on the other hand major improvements to the indirect tax system culminating in the introduction of a VAT in August 2002, have improved transparency and reduced the complexity of Customs clearance[42]. This not to say that the system is simple: including zero, there are six most commonly used Customs duty rates (Table 3 .2), as well as the surcharge, a number of high above normal Customs duty rates, specific duties on some products, and the PAL tax. Still, compared to the various para-tariffs in some of the other South Asian countries (especially in Bangladesh) the across-the-board surcharge is transparent with easy-to-see protective effects, and there are also relatively few *ad hoc* exemptions.

Table 3.18

Sri Lanka: Increase in Unweighted Average Protective Import Taxes between 2002/03 and January 2004

	2002-03			Jan 2004		
	Customs duties	Para-tariffs	Total protective rate	Customs duties	Para-tariffs	Total protective rate
All tariff lines	9.6	2.9	12.5	11.3	2.1	13.4
Non-ag lines	7.6	2.5	10.1	8.8	1.9	10,7
Agriculture	21.1	5.2	26.3	24.6	3.5	28.1

Notes The para-tariffs are the surcharge (20% in 2002/03, 10% after January 2004) and the 1% PAL tax. The averages are of MFN tariffs only: they do not take account of preferential tariffs. They include the ad valorem component of compound tariffs (tariffs which are the higher of an ad valorem or a specific rate) but not specific- only tariffs.

On average, the protectiveness of Sri Lanka's tariffs increased a bit in January 2004, with increases in average Customs duties partly offset by the reduction in the tariff surcharge. Tariff rates are also quite dispersed (Fig 3.10). A recent paper has reported the results of firm level estimates which have compared domestic-market effective protection rates for manufacturing in 1991 with effective protection rates in 2002. These estimates find that. as expected, that there was a substantial decline in the

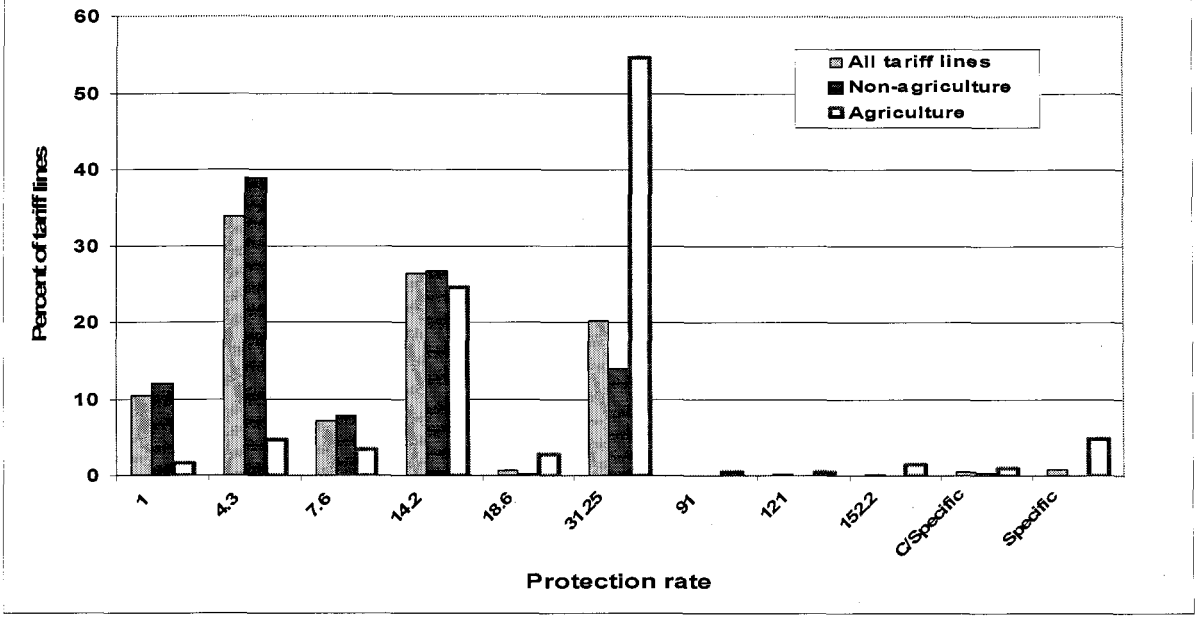
[40] ESCAP (2003). *Tariff and Trade Policy Framework for Sri Lanka in 2003.* Ch 3, p.8.

[41] These changes are on the Sri Lanka Customs department website at <www.customs.gov.lk>

[42] During the 1990s and before imports were subject to a "turnover tax" (three different rates) based on the dutiable value plus Customs duty and a 25% margin, and turnover taxes at the same rates were imposed on domestic production. In 1998, this was replaced by a "Goods and Services Tax" (GST) with VAT features, also imposed on both imports and domestic production. Parallel but separate from the GST and its predecessor turnover tax, to help finance the civil war, there was also a "Defense Levy" (later known as the "National Security Levy") initially at 3.5% and increased to 4.5% in July 1995. Like the GST, this tax was imposed at the same rates on imports and domestic production, so in principle it did not provide additional protection to Sri Lankan producers, but together with the GST, Customs duties and the PAL tax, it made the calculation of total import taxes enormously complicated.

EPRs over this period, from approximately 138% to 62%[43]. The still high effective protection rates in 2002 (approximately 138% to 62%[44]) resulted from lower average sub-sectoral input

Fig 3.10
Sri Lanka Jan 2004: Distribution of Protective Import Tax Rates



tariffs (6% to 15%) than output tariffs (18% to 25%). Bearing in mind that EPRs for most export activities are zero or negative, the decline after 1991 represents a substantial improvement in the economic efficiency of resource allocation in Sri Lanka, but the disparity between EPRs in 2002 for import substitution manufacturing and exporting (62 percent versus about zero) was still very large. Moreover, there were still big differences in domestic market effective incentives between manufacturing sub-sectors, with EPRs for 10 sub-sectors ranging from 25% to 125%. The ESCAP report recommends that the government move toward a low uniform tariff that would produce lower and less variable effective protection rates, but the changes introduced in January 2004 appear to have done the opposite, by increasing the general level of protection made available by tariffs, and probably increasing the variance of the effective protection rates as between different import substitution activities.

As already indicated in discussing Sri Lanka's non-tariff barriers to imports, agriculture trade policies have been especially difficult to manage, reflecting the basic underlying reality that production costs for the major import substitution food crops-especially rice, potatoes, onions and chilies-are very high relative to the prices at which these same products can be imported in most years. During the Uruguay Round, Sri Lanka bound all its agricultural tariffs at 50 percent (much lower than the agricultural bindings of India, Pakistan and Bangladesh-see Table 3.1) and following the loss of its Article XVIII.B case at the WTO, in July 1996 it removed all its remaining agricultural QRs, except for the import monopoly over wheat, which Sri Lanka argued was a WTO-consistent state trading enterprise arrangement. In 1997, the Paddy Marketing Board, which had controlled the domestic rice trade and

[43] Unweighted averages of the sectoral averages reported in ESCAP (2003) Table 3.2, p.10. The firm- level effective protection estimates on which the sectoral averages are based, were made by the Tariff Advisory Council.
[44] Unweighted averages of the sectoral averages reported in ESCAP (2003) Table 3.2, p.10. The firm- level effective protection estimates on which the sectoral averages are based, were made by the Tariff Advisory Council.

imports of rice, was closed. There followed a period of tariffs-only (mostly at 35%) protection of rice and the other principal import substitution food crops, during which imports of potatoes, onions and chilies surged and domestic production declined[45]. During this period, tariff policies for these crops attempted to achieve two incompatible objectives, protection of producers and low prices for consumers, by announcing import duty waivers during months of shortages when there was upward pressure on domestic prices. The unpredictability of these tariff changes created a great deal of uncertainty in the domestic commodity markets, in particular for traders and processors (e.g. rice millers) who were often caught with inventories of products they had purchased when tariffs were high, and were obliged to resell while facing import competition over much lower tariffs. Because of this risk, they were subsequently reluctant to offer farmers prices (e.g. for paddy) which fully reflected the tariff protection once the duty waivers had been removed and higher tariffs restored, so that these opportunistic tariff policies in this way undermined the protection for farmers that the tariffs were intended to provide[46].

These experiences led to strong reactions from farm lobbies[47]. They were influential in the decision in 1999 to put the whole of the agricultural sector on Sri Lanka's negative list in the India-Sri Lanka FTA, in the reintroduction of import licensing for rice during 2000, in the introduction of the 40% tariff surcharge in February 2000, and the use of specific rather than *ad valorem* tariffs for these crops (for potatoes from December 2000, and for rice, onions and chilies from January 2002). The 40% tariff surcharge brought the then 35% percent Customs duty rate on imports of these commodities up to a total protective rate of 50% (after allowing for the 1% PAL tax), just equal to Sri Lanka's WTO binding. Subsequent tariff changes which reduced the normally applied top Customs duty to 25% and the tariff surcharge to 20% and subsequently to 10%, cut the total protective rate for most agricultural commodities to 31%, but then increased them again slightly to 31.25 % in January 2004 (corresponding to the new normal maximum Customs duty of 27.5% and the reduced surcharge of 10%). At present (Fig 3.10) about 55% percent of Sri Lanka's tariff lines have a total import protection rate (Customs duties plus para-tariffs) of 31.25%, and most really high tariffs in excess of this level are for agricultural products, both very high *ad valorem* tariffs and specific tariffs. For example, new edible oil tariffs introduced in January 2004 (Customs duties plus para-tariffs) are prohibitive (152.2%)[48]. More significantly, the key domestic food crops which account for the bulk of agricultural production are protected against imports by specific duties. In about September 2003, the *ad valorem* equivalents of these duties (which vary with world prices) were estimated as follows[49]:

	Specific duty Rs /kg	Estimated ad valorem equivalent rate %
Rice	7	50
Chilies	30	34
Big onions	6	43
Other onions	5	17
Potatoes	20	133
Sugar	3.5	16

[45] Ranaweera (2003)
[46] For more on this see World Bank (2002, May)
[47] Kelegama (2003, October)
[48] The new Customs duties are 126% : they increase to 152% after adding the 10% surcharge, the 10% Cess on Customs duties over 45%, and the 1% PAL tax.. They are published on the Customs department website www.customs.gov.lk as RPO 06/2003 wef 01/01/2004.
[49] Estimates reported by Ranaweera (2003), p.8.

Specific duties have are also increasingly being used to protect other agricultural commodities. There is presently a specific tariff on sugar,[50] specific surcharges rather than the general percentage rate was used to increase edible oil tariffs between January 2001 and September 2002, and specific tariffs were introduced for various processed vegetables in 2002[51]. As indicated in Fig. 3, most of the compound specific tariffs (i.e. tariffs that are the higher of an *ad valorem* rate or a specified sum) and also the purely specific tariffs that are presently in force, are applicable to agricultural products.

In the future, if Sri Lanka is able to achieve its potential for fast economic growth based on export oriented manufacturing and services, the strong pressures that have emerged in recent years for protecting agriculture and for exempting it from the initiatives to further liberalize the trade regime, suggest that there is a real danger that its agricultural trade policies could develop along the lines of the agricultural trade policies of East Asian countries such as Korea. In these countries, fast economic growth based on manufactured exports and rapidly increasing wages and living standards, were accompanied by steadily increasing agricultural protection to offset the resulting pressures on the sector to increase its productivity and/or contract. These policies, which eventually led to prohibitively high levels of protection for favored rural industries, slowed down economic growth that would have been even faster without them, removed or diminished export opportunities for the rest of the world (including efficient developing country exporters) and increased the already large distortions in world agricultural markets.

Nepal

Reforms initiated in the early 1990s cut both the level and variance of tariffs in Nepal very substantially. Between 1989-90 and 2001-02, the unweighted average Customs duty fell from 39.8% to 13.7%, and whereas in 1989-90 almost 80 percent of Customs duties were over 25%, and more than 40% over 50%, in 2001/02 three quarters were 25% or lower[52]. However, beginning in fiscal 2001/02, this liberalization of the import regime has been partially reversed by the imposition of additional taxes (all applied to CIF prices) on top of Customs duties. In August 2003, the unweighted average protective rate of Customs duties plus para-tariffs was about 18 percent over all tariff lines, 17.8 percent for non-agricultural products and 19.6 percent for agricultural products (Table 3.1). These average protective rates are now just a bit above Pakistan's and not far below India and Bangladesh, so by this criterion Nepal is a moderate to high protection country by the standards of developing countries. The import taxes or para-tariffs are:

- A "Local Development Fee" of 1.5%
- "Special Fees" of 1% when Customs duties are 5% or less, 3% when Customs duties exceed 5%, 10% for vehicles (cars, motorbikes etc) and specific duties (Rs 1000/Liter) on petroleum products.
- An "Agricultural Development Fee" of 5% on imports of unprocessed agricultural products and of some processed agricultural products. In the case of paddy and rice, the fee is 10%.

These taxes were imposed to help finance extra government expenditure resulting from the conflict between the government and the Maoist guerillas, but unlike the National Security Levy in Sri Lanka (abolished in 2002) which was also imposed to help finance a civil war, they are not applied to domestic production and therefore increase protection of Nepalese industries. On average (Table 3.1) the taxes have increased the unweighted average protection rate over all tariff lines, from about 13.7 percent (Customs duties only) to about 18 percent (Customs duties plus para-tariffs). The extra protection

[50] The sugar specific duty was increased from Rs 3.5/KG to Rs 4.5/kg in January 2004. At low to moderate world sugar prices varying from say US 13-22 cents/Kg, this corresponds to ad valorem tariffs of about 22% to 35%.
[51] Central Bank of Sri Lanka, Annual Report, 2002, Chapter 9.
[52] Bajracharya, Pushkar (2003), p.4.

provided in this way is greater for agriculture (from 13.5% to 19.6%) than for industrial and other non-agricultural products (from 13.7% to 17.8%). The structure of the increase is as follows:

	Increase in protective rate (% of cif price)
Non-ag products with Customs duties ≤ 5%	2.5
Most non-ag products with Customs duties > 5%	4.5
Most vehicles (HS Ch 87)	11.5
Unprocessed ag products	9.5
Processed ag products with Customs duties ≤ 5%	2.5
Processed ag products with Customs duties > 5%	4.5
Paddy and rice	14.5

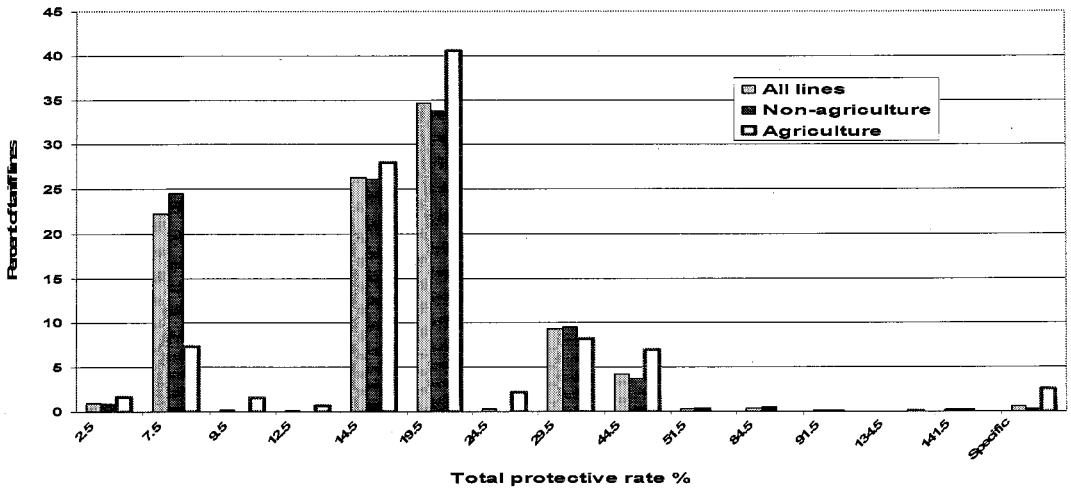
Cumulatively, these extra import taxes amount to a substantial increase in the protection to local producers, especially in agriculture. While they are generally applied across the board according to the level of the Customs duty rate and whether or not the product is "unprocessed", in some cases the taxes have been used selectively. For example, the 10 percent Agricultural Development Fee on wheat and rice imports increases the protection rate for wheat from 10% to 19.5% , and for rice from 10% to 24.5%, and imports of wheat four and other cereal flours (processed products) are subject to the 5% Agricultural Development Fee even though it is not applied to imports of most other processed agricultural products.

	Wheat	Rice
Customs duty	10	10
Local Development Fee	1.5	1.5
Special fee	3.0	3.0
Agricultural Development Fee	5.0	10.0
Total protective rate	19.5	24.5

The para- tariffs taxes have considerably increased the complexity of the Nepalese tariff. Without them, there are 8 *ad valorem* Customs duties "slabs" and some specific tariffs, but with the para-tariffs included, them there are 14 *ad valorem* protective rates, ranging from 2.5% to 141.5%, plus specific tariffs. The resulting distribution of total protective rates is shown in Fig 3.11. Most protective rates are either 14.5% or 19.5%, but some (principally industrial raw materials and equipment not produced in Nepal) are at 7.5%, while others are clustered at 29.5% and 44.5%. A fairly large number of Nepal's import substitution industries operate with the protection of these latter groups of high to very high tariffs, while benefiting from much lower tariffs for their imported equipment and raw materials and components e.g. producers of processed foods, sugar, juices, coffee, Portland cement, building stone and materials, soaps, matches, plastic goods, footwear, iron and steel products, furniture and batteries[53].

[53] Ibid

Fig 3.11
Nepal Aug 2003: Distribution of Total Protective Import Tax Rates



As noted previously, for India, Pakistan, Bangladesh and Sri Lanka, the volume of trade and of domestic production which is actually affected by regional preferential agreements (SAPTA, the India-Sri Lanka FTA and the India-Nepal Treaty of Trade) is negligible, and preferential tariffs can for the most part be safely be ignored in assessing the broad protection levels that the tariff system makes available to domestic producers. By contrast, about 30 to 40 percent of Nepal's imports normally come from India, about a third of its exports are to India, and all this trade is under the terms set by the Treaty of Trade between the two countries. Under this treaty:

- Subject to rules of origin and some exceptions for "sensitive" products, all Nepalese products have duty free access to the Indian market[54].
- Nepalese imports of unprocessed agricultural products from India are exempt from Customs duty in Nepal. However, they must pay the other fees and taxes described above, including the Agricultural Development Fee.
- For all other Nepalese imports from India, there are preferences equivalent to 20% of the Customs duty rate, for Customs duties of 40% or less, and equivalent to 10% of the Customs duty rate for Customs duties exceeding 40%.

On the import side, especially after allowing for the other import taxes described above, the resulting overall tariff preferences in Nepal for Indian manufactured goods are minimal, but a little more significant for unprocessed agricultural products. For example:

	MFN rate	Preferential rate for India
Industrial products subject to 5% Customs duty	7.5	6.5
Industrial products subject to 15% Customs duty	19.5	16.5
Industrial products subject to 25% Customs duty	29.5	24.5
Industrial products subject to 40% Customs duty	44.5	36.5
Industrial products subject to 80% Customs duty	84.5	76.5
Unprocessed agricultural products : Customs duty 10%	19.5	9.5
Paddy and rice: Customs duty 10%	24.5	14.5

[54] For more detail on the Treaty of Trade provisions, see Pursell and Pitigala (2001, September). New more restrictive rules of origin were introduced in March 2002.

Because of these very small tariff preferences for India, the relationship with India only very slightly reduces the protection available to Nepalese industries from its MFN Customs duties and para-tariffs. A much more important determinant of import competition for local industries is the large volume of smuggled imports from India, which either bypass Customs posts altogether, or which pass through Customs and avoid or underpay import taxes with the connivance of Customs officials[55]. Illegal trade in both directions over the long Nepal-India border is a longstanding and permanent concern in both Nepal and India, and among other things it severely limits the extent to which increases in Nepalese tariffs actually produce extra revenue or provide extra protection to local industries.

On the export side, the Indian preferences are substantial, and offer important export opportunities to Nepal, especially for products which are highly protected in India. But not surprisingly, the corresponding industries in India have been active and successful in lobbying for measures to make sure that exports from Nepal of such "sensitive" products do not grow too fast or become too great. This issue is discussed in Chapter IV on regional trade and regional trade agreements.

Nepal acceded to the WTO in December 2003, 14 years after it first applied. Like other recently acceding countries, it had to agree to a more comprehensive and rigorous set of constraints on its trade policies than those applying to existing members. In particular, it has bound 100 percent of its tariff lines including all of its non-agricultural lines (Table 3.1): this compares with much lower percentage coverage of non-agricultural tariffs by the other South Asian countries, especially Bangladesh and Sri Lanka. Its bindings are also considerably lower than the bindings of the other South Asian countries, particularly in agriculture. The accession negotiations also focused on Nepal's para-tariffs (in WTO terminology "Other Duties and Charges" or ODCs) and Nepal has agreed to phase them out over a period of 2-10 years, and to bind them at zero once they are eliminated[56]. This will simplify the administration and improve the transparency of Nepal's tariff system, but it won't necessarily lead to lower protective tariffs, since for most tariff lines the present applied rates (Customs duties plus para-tariffs) are well below the bound rates.

Bhutan

Bhutan is landlocked with borders with India, China and Sikkim, and its only road connections suitable for merchandise transport are with India. It has a free trade agreement with India under which Bhutan's exports are exempt from Indian tariffs, and Bhutanese imports from India are exempt from Bhutan's import licensing and from tariffs. However, for a tiny economy, some of Bhutan's tariffs are rather high and are quite escalated. For example, cotton and synthetic fibres zero, textile yarns zero, textile fabrics 20%, and garments 30%, flours 10%, baked products (biscuits etc) 30%, fresh vegetables 10%, and processed vegetables 30%[57]. Potential protection is further increased by a sales tax which is reported to be applied to imports but not to the production of local import substitution firms, which therefore also provides some protection against imports from India, despite the free trade agreement[58]. At present, no direct bonded imports are possible through India, so Bhutan's MFN tariffs are of little or no relevance. except for imports which come by air. However, if and when bonding arrangements are made with India, *a priori,* its present arrangements would appear to be economically inefficient in some ways, by diverting potential imports from third countries to higher cost suppliers in India, and by providing excessive protection to local import substitution production. A small empirical study which would take account of the transport costs of imports from alternative sources and which would estimate the likely

[55] For recent discussions of this informal trade, see Pohit, Sanjib and Nisha Taneja (2002), and Bajracharya, Binod and ....

[56] WTO (2003, August). *Report of the Working Party on the Accession of the Kingdom of Nepal to the World Trade Organization.* WT/ACC/NPL/16

[57] Ministry of Finance, (2002, January) *Bhutan Trade Classification Customs Tariff and Sales Tax Schedule.*

[58] See the discussion in World Bank (2002, January) *Bhutan Private Sector Survey,* pp 14-15, 116-117, and 141-143.

trade diversion and economic welfare consequences of this protective structure and the FTA with India, would be useful.

Maldives[59]

Customs duties on imports in the Maldives provide about two thirds of government revenue, since there are no other indirect taxes. In 2002 the unweighted average Customs duty was 20.8% over all tariff lines, 21.2% for non-agricultural products and 17.8% for agricultural products. All tariffs are bound, mostly at 30%. Maldives is a member of SAPTA, but only provides very small preferences (for example, 22.5% tariffs instead of MFN tariffs of 25%) for a limited number of products. For a very small economy, protective tariffs are quite high, and even though there is no local production of most imported goods, the tariffs have the potential to shelter pockets of high cost local production and to distort resource allocation away from economically more efficient activities, especially export related activities. As emphasized in the December 2002 WTO TPR report, the principal needed reform is to substantially reduce the protective Customs duties and to use a VAT-style indirect tax as the principal source of government revenue.

Anti-Dumping and Safeguards

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. AD measures are intended to offset injury to the national industry resulting from export sales at prices lower than prices in the domestic market of the exporter (dumping)[60]. Countervailing duties are imposed to offset foreign subsidies. Safeguard duties provide temporary extra protection to an industry while it adjusts to import competition. Since the mid-1980s, anti-dumping has been by far the most frequently used of these three instruments, and the most prolific users were initially the developed countries. However, as tariff and non-tariff barriers came down in developing countries in the 1980s and after, they also became active users of anti-dumping.

South Asian exports have frequently been harassed by both AD and CVD measures, mostly in developed countries. None of the South Asian countries used anti-dumping until India started in 1992/93.

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[59] This section mainly relies on the December 2002 WTO TPR report on the Maldives, pp 29-38

[60] For anti-dumping duties to be levied it must be shown that (1) "dumping" exists, as measured by a "dumping margin" equivalent to the excess of the "normal value" of the product in the exporting country over the export price to India, and (2) that the dumped imports are causing or threaten to cause "material injury" to the local industry. If both these allegations are upheld, an anti-dumping duty sufficient to eliminate the "injury" to the local industry, but no higher than the "dumping margin", can be imposed. In the absence of information from the exporting firms, the "normal value" of the exporter has been constructed by the Indian AD Authority on the basis of "best available information", most of which was provided by the complaining Indian firms. In a number of cases the "normal value" was inferred from production costs in India plus an allowance for reasonable profits. "Material injury" is defined very broadly and includes practically any actual and also potential adverse consequence of competition from the dumped imports. It includes cases where the complaining domestic firms are profitable, but where the AD Authority assesses that these profits are lower than they would have been in the absence of the "dumped" imports. Nearly all AD duties are specific and typically calculated as the additional import duty needed to enable the complaining domestic firms to sell at "fair" prices which take account of their production costs plus a "reasonable" margin for profits. Until the late 1990s they were usually set in Rupees per quantity unit (per kg, per ton etc) but since then most have been set in $US per quantity unit in order to avoid the decline in the *ad valorem* equivalent of Rupee AD duties over time resulting from inflation and exchange rate devaluation. Starting in the second half of calendar 1998, AD duties in a number of cases have been set as the difference between specified reference prices and the import-duty- inclusive price of imports, provided that the resulting AD duty does not exceed the "dumping margin. This provides a motivation for the exporter to set his prices such that the duty inclusive price will equal the reference price and so ensure that no AD duties will be imposed. If this happens, the tax imposed on the Indian buyers of the imported product is collected by the foreign exporter rather than by the Indian government.

Pakistan's first AD case was decided in November 2002. Bangladesh, Sri Lanka and Nepal do not use AD, although there are strong pressures to introduce anti-dumping in all three, especially following two recent Indian anti-dumping cases which resulted in the imposition of duties on imports from Bangladesh and Nepal. The lack of interest in anti-dumping in earlier years was the consequence of the region's highly protectionist policies. Very high tariffs and unrestricted use of QRs obviated any need for other ways of keeping imports out.

This was most apparent in India prior to its 1991/92 trade policy reforms, when a basic principle of the import licensing system was to allow imports only when the product was "essential" but not available from domestic producers. The 1991/92 reforms removed import licensing from most intermediate manufactured materials and from machinery and equipment, and started a process of annual reductions in tariffs. Initially, most domestic manufacturers of intermediates were more than adequately protected by tariffs and by the very large real devaluation of the Rupee between 1986 and 1992. Despite this, some industries began to feel the effects of import competition and India's first three anti-dumping cases were initiated in 1992/93. As tariffs declined, anti-dumping activity increased[61]. As of March 31 2003, a total of 153 AD cases had been initiated, 30 of them in the previous 12 months[62]. These cases involve over 100 products imported from 47 countries -- 17 developed, 13 low-income developing, and 17 others, including middle-income developing countries, FSU countries etc. By far the most frequent targets of complaining Indian firms have been exporters in China, followed by exporters in Taiwan, EU, South Korea, Japan, USA, Singapore, Russia, Thailand, Indonesia and Brazil in that order. The cases affect many more individual foreign exporting firms -- probably well over 1000 -- since AD duties are firm-specific, often with different duties applied to imports from three or four different firms in the same country. 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, following the final phase-out of import licensing of consumer goods in April 2001, anti-dumping is increasingly being used against imports of consumer goods.

Anti-dumping activity increased sharply at the time of the East Asian crisis around 1997-98, and has continued increasing since then, with 19 new cases in 1999/2000, 28 in 2000/01, 30 in 2001/02, and 30 in 2002/03. It continued at a rapid tempo during 2003/04. Apart from the impetus resulting from reductions in world prices and the removal of most QRs, anti- dumping has expanded as a result of active promotion by the Directorate General of Anti-Dumping (DGAD) in the Ministry of Commerce, and country-wide liaison for the business community with the DGAD in Delhi provided by DGFT offices in 30 port towns and cities. By contrast, as of March 2003, no CVD cases and only 15 safeguard cases had been initiated. Extra protection through anti-dumping is preferred by domestic industries because it is generally more easily obtained[63], more protective, and longer lasting[64] and is also preferred by most administering government authorities. Unlike safeguard rules, the AD rules contain no provisions for compensating the affected exporting countries.

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[61] The anti-dumping cases are targeted against imports from particular firms in particular countries, and for the same product the AD duties can vary according to the firm and the country. In many of these cases, a separate (usually higher) higher duty than the duties on imports from the individual targeted firms is imposed on "any other exporter" from that country.

[62] India, Ministry of Commerce and Industry, Directorate General of Anti-Dumping and Allied Duties. *Annual Report2002-2003.*

[63] Once an AD case is initiated, it is almost certain that AD duties will be applied. There are only a few exceptions so far. One early case (styrene butadiene rubber in 1992/93) ended with a finding of no injury attributable to dumping. The same industry reapplied and obtained AD protection in 1998, however. In another case (newsprint) AD duties were recommended by the AD Authority but were not imposed by the Ministry of Finance. Of the 153 cases initiated up to March 2003, only 6 did not result in the imposition of AD duties.

[64] All the Indian AD duties have been imposed for a period of five years, which is the maximum allowed by the Indian legislation and the WTO rules. However, they can be reviewed and renewed at the end of this period for another five years, and this can continue indefinitely.

Anti-dumping 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. Though seldom explicitly stated, 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.

First, the foreign firms targeted and penalized by the anti-dumping cases are almost always the most competitive that have the largest and/or fastest-growing market shares. Their export prices to India have typically been within the range of prevailing prices for their products in international markets, but under the AD laws such facts are irrelevant if a "dumping margin" and injury to domestic firms are established. Consequently 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 these firms to the prevailing normal level of international prices. In a number of the Indian cases, the AD Authority stated that evidence that the Indian firms requesting AD protection were themselves exporting at the same or similar prevailing world prices was irrelevant to the case. This attitude in turn signals other exporters to charge "reasonable" prices or also face anti-dumping actions, and results in a real terms-of-trade loss to India[65].

Second, the anti-dumping cases have been greatly increasing the protection of industries producing numbers of important and widely used intermediate materials. Until the recent tariff reduction program, even without the additional anti-dumping duties, the tariffs protecting these industries were extremely high by developing country standards, generally about double the levels of intermediate material tariffs that the government committee (the Chelliah Committee, which recommended the post 1991/92 tariff reduction program) said should be achieved by 1996/97. For example, following the 2002/03 budget, many of the tariffs on the intermediate products subject to AD duties were 30%, equivalent to 36% after allowing for India's SAdd duty, compared to Chelliah Committee targets of 20 or 25 percent. The majority of these tariffs have now been reduced to 20%, but the *ad valorem* equivalents of AD duties vary from about 10 percent to 80 percent, with most in a range of approximately 20 to 50 percent. This means that total import duties on imports of these materials from foreign firms subject to the AD duties, are mostly in a range of roughly 40 to 70 percent.

Third, the Indian anti-dumping cases have been reinforcing the market power of highly concentrated Indian industries. A study of AD cases up to mid-1999 indicated that of 29 products subject to AD cases in which information is provided on the structure of the Indian industry, there was only one Indian producer for 11 products, only 2 Indian producers for 5 products, and 3 Indian producers for 7 products. In only 6 of these 29 cases were there 4 or more Indian producers[66]. That the market power of the Indian producers was being exercised was apparent from a number of factors, including the

[65] For a number of products, AD duties have first been imposed on imports from firms in one or a few countries, and then a new case has later been initiated and AD duties imposed on imports from firms in selected other countries. The texts of the AD cases make it clear that the AD Authority intends that AD duties imposed in a first case are intended as a warning to exporters in other countries to charge "fair and reasonable" prices and to not indulge in dumping when exporting to India.

[66] Aggarwal (2003) reports that of 97 cases she investigated, there were only three in which there were more than 5 petitioners, and in 90% of the cases the number of petitioners was between one and three. In the cases where there was only one petitioner, the average market share was 89.7%. This observation is confirmed by Prasad (2003) who comments that fragmented and dispersed industries find it difficult to meet the "standing requirement" for initiating an AD case i.e. the requirement that the petitioning firms between them have a specified minimum market share.

profitability of a number despite considerable excess capacity, and in other cases export sales at prices generally about the same or lower than the "dumped" import prices about which the same firms were complaining[67]. For potassium permanganate and hot rolled steel coils – both the subject of anti-dumping cases in India – the Indian industry had been the subject of anti-dumping cases brought against it in the EU.

Fourth, two new bureaucratic bodies[68] have been created to implement the AD and safeguards policies and given considerable discretionary power over India's trade policies. The most active by far is the DGAD. To give general advice, prepare for and represent private firms in anti-dumping cases, a whole new specialized service industry has been created of accounting and economic consultants, technical specialists and lawyers, some of whom are ex-employees of the DGAD. In its own terms the system has been administered in a transparent way in that the proceedings of each case including the arguments and evidence presented and the reasons for recommendations are summarized and promptly published, and lists of cases initiated and completed are provided to the WTO. But the system is *ad hoc* and distinctly non-transparent in other more fundamental respects. In addition to the uncertainty it creates for Indian importers and foreign exporters, it has created many incentives for rent-seeking behavior. The rent-seeking opportunities are obvious, since a successful AD case against individual exporting firms in other countries limits their ability to compete in India and might well exclude them from the Indian market altogether, perhaps indefinitely[69]. Such a judgment correspondingly hurts the Indian importers with whom the foreign firms have links, gives extra protection to domestic producers, and reduces or eliminates the competition faced by firms exporting to India that are not subjected to AD actions.

Fifth, 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 retaliatory anti-dumping actions in their export markets. Between 1991 and July 2003, 77 AD cases were initiated against Indian exports in 15 countries, and 31 CVD (anti-subsidy) cases in 5 countries. Added to already high tariffs, AD duties in India 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 that 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[70].

Finally, the increased protection and prices of key intermediate materials resulting from the proliferation of AD cases since 1992/93 has implications for the continuing liberalization of Indian trade policies. It raises the costs of products which use these materials, reinforces the resistance of these industries to tariff cuts, and motivates them to press for offsetting extra protection For example, during a period of low international steel prices during the late 1990s until about 2003, AD duties added to already high protection of the Indian steel industry, which fed into the costs of producers of machinery and equipment, and a wide range of steel products such as steel pipes, consumer appliances and automobiles and trucks. More generally, during this period, increased protection and prices of intermediates increased the production costs of consumer goods just as India was being obliged to remove

[67] In many of the Indian cases, the AD Authority explicitly states that the prevailing level of international prices is irrelevant, including cases where the complaining Indian industry was exporting the same product at about the same prices as the alleged "dumped" import price. In taking this position, the AD Authority is correctly interpreting the Indian law and the WTO AD agreement.

22 Safeguards are administered separately from the DGAD, in the Ministry of Finance.

[69] The repeated renewal of anti-dumping measures to keep out competitors for long periods is well documented in the literature on anti-dumping in other countries. A colorful but reliable account of the US experience is in Bovard (1991).

[70] A possible motive for introducing AD is to deter other countries from using AD against a country's exports (Aggarwal, 2003). This does not appear to have been a motive in India, at least explicitly.

import licensing. These increases in turn fueled arguments and pressures for higher tariffs, many of which were not constrained by WTO bindings and the use of other protective techniques.

By contrast to anti-dumping, the safeguards cases so far concluded in India[71] appear to have been much less economically damaging. The duties imposed seem to be lower than the *ad valorem* equivalent of most AD duties, are in place for shorter periods (one to three years) and most decline before they are phased out. Most importantly, the firms requesting safeguards protection have had to demonstrate that they are restructuring in order to face the import competition without the extra protection. Initially, in accordance with the main thrust of the WTO agreement, the safeguards duties were non-discriminatory, and they applied to all imports of the concerned products from all countries. Subsequently, however, as permitted by the WTO agreement in certain circumstances, the law was amended to allow for the use of tariff rate quotas. Because the quota is generally rationed, this kind of safeguard duty has the potential to create considerably more economic damage than the safeguards duties so far imposed.

An argument can conceivably be made for imposing temporary safeguard duties while a local industry adjusts to import competition, but except for meeting the desire of local industries for extra protection, there is no coherent economic rationale for AD measures. Sales at prices which are sometimes below average production costs or which discriminate between buyers and markets are normal and necessary in efficiently functioning contestable markets, whether domestic or international. In India, as in other countries, the use of anti-dumping is justified by arguing that it is needed to deal with predatory pricing by foreign firms, which otherwise will undercut and drive Indian firms out of business and then raise their prices and exploit Indian buyers. Detailed studies of anti-dumping cases in other countries[72] have shown that the alleged dumping firms have almost never gained sufficient market power to raise prices, even supposing their alleged dumping caused competitors in the importing country to close. The existence of such market power is also quite implausible in the Indian cases. In a number of these, imports were coming from 20 or more countries. In others, even though fewer supplying countries were involved, some of these were very large (USA, China) with a number of strongly competing domestic firms.

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[73]:

- Repealing the AD law and using the safeguards provisions as the main safety valve for responding to protectionist pressures. In this regard, it should be noted that there is no WTO obligation on member countries to have an AD law on their books: the only obligation is that if they have an AD law, it should be consistent with the WTO agreement.
- Channeling all or most cases to 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 to make predatory pricing and the likelihood of subsequent market power preconditions for the imposition of AD measures.

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[71] For an account of Indian safeguard cases up to mid-2003, see Gupta (2003). As of mid-2003, hearings on 14 petitions for safeguard had been concluded, of which 8 had resulted in the imposition of safeguard duties and 6 had either been rejected, dropped or delayed.

[72] J. Michael Finger, 1998. *GATT Experience with Safeguards.* World Bank, Policy Research Working Paper 2000. October, p.13.

[73] See discussion in J. Michael Finger (1998) pp.14-16 and in J. Michael Finger (ed), 1993. *Antidumping: How it Works and Who Gets Hurt.* University of Michigan Press, Ch. 4.

Despite the economic desirability of reforms along these lines, the political economy of anti-dumping is such that, once anti-dumping laws are introduced and operational, it may be difficult to alter them substantively without similar reforms being instituted and supported internationally, in particular at the WTO. Since there is at present no sign of the latter happening, the most effective way of constraining anti-dumping activity may be through administrative measures that make it more expensive, time consuming and difficult for petitioning companies to succeed in anti-dumping cases. In that regard, it is relevant to note that in December 2003, the EC asked for consultations with India on 27 recent AD cases affecting EC exporters[74]. The EU complaint questions many key aspects of the procedures followed by the Anti-Dumping Authority in these cases, basically claiming that the investigations were superficial and not sufficiently detailed or careful, and did not provide exporters with sufficient information or time to effectively defend themselves. One possible outcome of this dispute could be that in future the cost and difficulty for Indian firms of obtaining favorable AD judgments will increase, thereby reducing the number and scope of the cases that are initiated.

Finally, an unfortunate consequence of anti-dumping activity in India is that producer groups looking for ways to obtain extra protection in the neighboring South Asian countries are using India's example as another reason why their governments should introduce AD laws and develop the technical capacity to implement them. As already discussed, this has now been done in Pakistan where the first two AD case have been decided, and anti-dumping has become the principal role of the Tariff Commission. Similar pressures and arguments for introducing anti-dumping are being heard in Bangladesh, Sri Lanka, and Nepal, but, as in Pakistan, the economic costs of AD are almost completely lost or ignored in these discussions: all that is being heard is that AD is a legitimate WTO-sanctioned way of dealing with "unfair" foreign competitors.

The willingness and interest of various international and national organizations to provide technical assistance to establish AD capabilities in developing countries, make succumbing to such pressures much easier. There are also no systematic economic evaluations of the consequences of Indian anti-dumping. Some applied, policy oriented empirical research on this topic could provide the basis for, at the least, some public questioning of AD in India. Such studies, if well done, could also be useful to other South Asian governments presently under pressure to go down the same path.

Tariff Collection Rates

Tariff or import duty collection rates -- import duties collected divided by imports -- should be easily available. In practice they are not. They are in some ways useful indicators of the effects of tariffs, since they measure the extent to which, on average, tariffs increase the cost of imported goods to importers. In most circumstances, however, they systematically understate the protection that tariff systems provide to domestic production. Since the usual tariff structures involve a range of tariffs from low to high, imports of high-tariff products are reduced more than low-tariff products and therefore have a lower weight in the average, import-weighted average collection rate. At the top end of the tariff structure, it is quite usual (especially in South Asia) for the tariffs to be almost prohibitive or prohibitive, so that there are negligible or no imports, with the result that the most protected domestic products often receive almost zero or zero weights. If the objective is to provide an empirical indicator of the average protective effects of tariffs as regards established domestic industries, it would be better to weight tariffs by the value (preferably value-added) of the domestic production the tariffs protect, but matching disaggregated production or value added with tariffs is difficult and time consuming[75].

[74] WTO document WT/DS304/1 dated 11/December 2003. See also *Weekly Index,* Vol XX No 38 17-23 December.

[75] Import duty collection rates would accurately indicate changing levels of protection to domestic production if there were just one uniform tariff, but in that case the weighted average would be the same as the uniform tariff rate and there would be no need to calculate it. An extreme example of a misleading duty collection rate would be a situation in which all domestic production is

Despite these problems, the levels of and trends in duty collection rates are a useful supplement to more detailed information on tariff structures and trends, provided their drawbacks are kept in mind. In South Asia, as regards levels, they are consistent with inter-country comparisons of other protection indicators, and as regards trends, they are consistent with those of such other indicators as unweighted averages of tariffs by tariff line.

Levels in 2001. Looking at levels first (Table 3.19 and Fig 3.12), the aggregate collection rates are consistent with the earlier discussion of tariff rates and structures, which show that in 2000 India has the highest tariffs in South Asia by a clear margin, followed by Bangladesh, Pakistan, Nepal, and Sri Lanka in that order. These collection rates have been estimated by excluding the (in principle) non-protective indirect taxes imposed on imports[76], but taking into account the other protective taxes described earlier in addition to Customs duties i.e. in India the SAdd duty; in Bangladesh the IDSC duty, the license fee[77], supplementary duties, and the effects of VAT exemption for domestic producers; and in Sri Lanka the Customs duty surcharge (40% of Customs duties in 1999/2000). In Pakistan and Nepal, Customs duties were the only protective import duties. Comparing these South Asian collection rates with China's in 1998 (Fig 3.27-28), China's rates (2.7%) prove to be about half that in the most open of the South Asian economies (Sri Lanka) and about one-seventh of India's (17.5%). Since 2000/01, tariffs have been reduced in India, Pakistan, Bangladesh, and Sri Lanka, but it is unlikely that these reductions would greatly change these comparisons.

Aggregate import duty collection rates provide an indication of the average tariff- induced increase in the prices of imports above their average cif price, including the prices of inputs imported by exporters generally duty free as a result of one of the standard exemption or drawback schemes. In order to provide a better indication of the price-raising effects of tariffs on imported products which are either intermediate or final goods for the domestic market, it is useful to deduct duty-exempt intermediate inputs imported by exporters from the import duty collection rate. Where data is available another adjustment has also been made for petroleum, oil and lubricants (POL) imports by removing tariff revenue from such imports from the numerator and POL imports from the denominator. POL products are a very large import item for all the South Asian countries, and how the import taxes are described is arbitrary and has little relation to protection objectives. Some countries apply high excise or fuel taxes and low Customs duties; others do the opposite.

The results of these adjustments are shown in Table 3.20-25 and Fig 3.13-26. Data for both adjustments was only available for India and Bangladesh. In India the combined effect is to raise the collection rate for domestic-use imports excluding POL well above the aggregate collection rate, to 26.6% compared to 17.5%. In Pakistan, excluding POL also gives a considerably higher domestic-use collection rate (14.6% versus 10.3%). Separate data on imported inputs used by exporters was not available but if it

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protected by prohibitive tariffs so that there are no imports, and the only imports are of inputs for local industries all exempt from tariffs. In that case the import duty collection rate would be zero even though nominal protection could be extremely high and effective protection even higher. Import duty collection rates for obvious reasons are also misleading indicators of average protection levels when imports are restricted or effectively banned by QRs.

[76] Pakistan, Sri Lanka and Nepal publish customs revenue statistics which distinguish customs duties from indirect taxes on imports. However, in India until 2001/02 the two were not distinguished either in published statistics or it seems in aggregated form in internal records. The estimates given in Table 3.20 for India are from unpublished research on this and related topics (Garry Pursell, *Indian Trade Policies Since the 1991/92 Reforms*: see notes to Table 3.20). In 2001/02 the protective taxes (Customs duties and the SAdd) and indirect taxes on imports were distinguished for the first time in the annex papers to the 2002/03 budget. As in India, Bangladesh published statistics do not separate out domestic indirect taxes paid on imports from other Customs taxes. The data estimates reported in Table 3.22-23 has been compiled by Bank staff from data kindly supplied by the National Board of Revenue. A difficult and time consuming part of this task was estimating the protective component of VAT and supplementary duties, owing to the full or partial exemption of some domestic products from these taxes.

[77] Since removed in FY03

were, it would probably not greatly increase the collection rate, since a large share of Pakistan's exports use domestic cotton, and imported export-related inputs are a relatively small share of total imports.

In Bangladesh, where taxes described as Customs duties on POL product imports were quite low, removing such imports reduces the average collection rate below the aggregate rate. However, imports of inputs for Bangladesh's export industries, mainly fabrics for the readymade garment sector, account for a large share (36% in 2000/01) of total imports, and netting these out gives a much higher collection rate than the aggregate rate, 16.7% versus 11.7%. This is consistent with the level and structure of Bangladesh's tariffs, which suggests that the domestic market for Bangladesh industry is the second most-protected in South Asia next to India, at least in terms of the protection available from tariffs.

In Sri Lanka and Nepal no data is readily available for either adjustment. In both cases, however, it is likely that adjusting for duty-exempted inputs imported for export production would substantially increase these countries' duty collection rates. For example, if these imported inputs (fabrics etc) were 70% of Sri Lanka's garment exports, they would account for about 30% of Sri Lanka's total imports in 1999/2000, and adjusting for this, the import duty collection rate would be 7.2% in this year rather than 5%. This is still a low collection rate in comparison with the other South Asian countries, however, and is consistent with the generally open and low protection policies that Sri Lanka is presently following, albeit with some significant exceptions. Garments using duty exempt imported fabrics and other textiles as inputs are also Nepal's largest export (about 28% of total exports in 1999/2000), followed by carpets which are also fairly intensive users of imported fibers and yarns. If duty-exempt imports for exporters were 30% of Nepal's total officially recorded imports, the average duty collection rate would go up from 10.1% in the aggregate to 14.4%, probably a better indication of protection conditions in the domestic market than the lower aggregate collection rate.

Trends. Tariff collection rates have declined in all the South Asian countries since the late 1980s and during the 1990s, but starting from very different levels and at different rates (compare Figs 3.13 - 26) :

- In India (Table 3.20 and Figs 3.13 and 3.14) collection rates peaked at extremely high (62 percent -- surely a world record) levels in 1987/88, came down slowly for some years, and then fell rapidly during the early 1990s along with the pre-announced reductions that were part of India's 1991/92 reforms. Over the whole period since 1979/80, it can be seen that netting out POL and export-related imports systematically raises the collection rate, with especially wide gaps between the aggregate rate and the adjusted rates during the 1980s and again for a few years between 1998/99 and 2000/01. The rising trend until the peak 1987/88 had little to do with changes in protection levels, however, since until 1991/92 practically all imports were subject to licensing: the main use of the tariffs during the 1980s was to mop up economic rents from the issue of import licenses. It is possible that implicit nominal protection and untaxed economic rents from licensing may have been higher in the earlier years than later on when tariffs were higher. The 1990s decline in the collection rates leveled out in about 1997/98, trended upward for two years after 1998/99, and then declined again in 2001/02. The sharp drop in 2001/02 was probably due mainly to the removal of the 10% customs duty surcharge in the March 2001 budget. It is probable that there will be another drop in 2002/03 resulting from the reduction in the general maximum basic customs duty from 35% to 30% in the 2002/03 budget.
- By contrast with India, in Pakistan, between 1990/91 and 2000/2001 collection rates were in a strong downward trend throughout the period and fell in every year except one (Table 3.22 and Fig 3.15-19). Netting out POL imports shifts the rate up uniformly during the entire period, but proportionately more in the later years. As noted previously, adjusting further for export-related imports would shift the collection rate up again, but probably not by much in view or the relatively low level of imported inputs used by Pakistan's textile and clothing exporters. It is likely that this downward trend will

continue during 2001/02 and 2002/03 as a result of the reductions in the general maximum tariff, now 25%, and the relatively few exceptions being allowed to this general maximum.

- The estimation of reasonably accurate collection rates in Bangladesh is especially difficult owing to the multiple protective import taxes that are used in addition to customs duties, and they have only been calculated for five years, 1991/92 and for the four years 1997/98-2000/01 (Table 3.23-24 and Fig 20-21). Collection rates were considerably lower during the latter four years than in 1991/92, reflecting the customs duty reductions during the late 1980s and 1990s, but the decline stopped in 1998/99 owing to the new import taxes. It is probable that the earlier decline in collection rates has resumed during 2002/03 following the tariff reductions announced in the 2002 budget. As shown in Fig 3.20, netting out POL imports in this case reduces the collection ratio, but adjusting for export-related imports increases it substantially. With this done, it is interesting to note that with both adjustments, the collection ratio was not only considerably higher than the collection ratio for aggregate imports, but also trended up slightly between 1998/99 and 2000/01.
- In Sri Lanka, the peak tariff collection rate (19.8 % of total imports) during the past 20 years was reached in 1998/99, far lower than the peak levels seen in India, Pakistan and Bangladesh. The increase during the 1980s was associated with the replacement of import licensing by tariffs, a key part of the early Sri Lankan reforms, and also with the phasing out of export taxes applied to exports of plantation crops, a major source of tax revenue the early 1980s. After 1998/99 the collection rate fell steadily for the next 11 years until in 1999/2000 it reached 5%, about one quarter of its peak level (Table 3.25 and Fig 3.22-23). Tariff reductions announced in the 2002 budget will probably take the collection rate below 5% during 2002/03.
- Nepal's maximum tariff collection rate (Table 3.26 and Fig 3.25-26) since 1984/85 (just over 14% in 1989/90) was much lower than the pre-liberalization maximum collection rates of the other South Asian countries during the same period. Nepal's trade liberalization and tariff reductions during the early 1990s sharply reduced the collection rate from this level over two years, but it then stabilized at between about 8 and 9 percent of imports. It probably remains at about this level in 2002.

Tariffs and Government Revenue

In South Asia as elsewhere in the developing world, one of many reasons governments are reluctant to cut tariffs is their fear of losing revenue that would be difficult to replace by increasing domestic taxes. Tables 3.20-27 and Figs 3.13-30 give some indicators of the current importance of tariff revenue for India, Pakistan, Bangladesh, Sri Lanka and Nepal, and also some comparisons with China. The following points are worth noting:

- Revenue from tariffs is still a big share of GDP in all these countries: 1.6 percent in India, 1.87 percent in Pakistan, over 2 percent in Bangladesh and Sri Lanka, and almost 3 percent in Nepal. In China, by contrast tariff revenues are currently only around one half of one percent of GDP, indicating that China could if it wished move to free trade with minor consequences for government finances. In South Asia, other taxes would have to bring in revenue on the order of one or more percent of GDP to support further tariff cuts, even after allowing for substantial potential increases in import-to-GDP ratios.
- In Nepal and Bangladesh, import duties account for much higher shares of total government current revenue, total taxes, and total indirect taxes than in India, Pakistan and Sri Lanka. But the dependence of all the South Asian countries on tariff revenue is much higher than China's, where 1998 tariff revenue only accounted for 3.1 percent, 3.4 percent and 4.2 percent respectively of total government revenue, total taxes, and total indirect taxes. India's dependence on revenue from tariffs is three to four times that of China; Bangladesh's, 7 to 9 times.
- The share of tariff revenue in the economy and in government revenue depends on average tariff collection rates in relation to imports, the share of imports in GDP, and the size of the government in

relation to the economy. Reflecting higher tariffs on average, India has the highest import duty collection rate of the five South Asian countries (17.5 percent in 2001) and Sri Lanka by far the lowest (5 percent in 2000). Since Indian imports are low in relation to GDP (only around 11 percent) whereas Sri Lankan imports are over 40 percent of GDP, the share of import duties in tax and total government revenue in the two countries is about the same. Somewhat surprisingly, the average import duty collection rate in Nepal (which reflects tariff preferences affecting about 40 percent or so of its imports which come from India) is more than double Sri Lanka's. Together with its relatively high import/GDP ratio, this explains the very high shares of tariffs in GDP and government revenue in Nepal. Once again, import duty collection rates in China (around 2.7 percent) are far lower than in all the South Asian countries. India's collection rate is almost 7 times China's and even Sri Lanka's is about double.

- Since imports increase with lower import duties, import duty collection rates tend to be negatively correlated with the share of imports in GDP. This relationship is apparent if India (high collection rate, low share of imports in GDP) is compared with Sri Lanka (low collection rate, high share of imports in GDP). However factors other than protection levels, especially the size of the economy (large economies tend to trade less than small economies) also affect openness, and as a result collection rates are roughly similar in Pakistan, Bangladesh and Nepal even though their import/GDP ratios differ substantially. In this regard, however, it is pertinent to note that China's import/GDP ratio (21 percent in 2001) is about double India's even though China's economy is more than twice the size of India's. In 2001 China's import/GDP ratio also exceeded the import/GDP ratio of Pakistan (14.7 percent) and Bangladesh (17.5 percent) which had economies which were respectively 5.7 percent and 4.5 percent of China's. These relationships suggest that there is considerable potential in South Asia for increases in the volume of imports to reduce the revenue losses that would result from tariff cuts. This effect could be reinforced if tariff cuts bring some of the very substantial illegal smuggled trade -- especially in Nepal, Bangladesh and Pakistan --back to legal, tax-paying channels.

Although tariffs still provide large shares of government revenues in South Asia, this dependence has diminished substantially except in Nepal during the past 10 to 15 years, and other non-trade taxes have increased their share in total revenue. In India (see below) the most important change has been the increasing role of corporate and personal income taxes. The other principal change has been the introduction of VAT-type indirect taxes, which are now in place in all the South Asian countries and which have become for all of them the principal indirect tax. The immediate motivation for employing VAT-style taxes is their efficiency as revenue raisers, especially the built-in motivation for buyers of intermediate inputs to ensure that their suppliers provide them with adequate documentation that VAT taxes on these inputs have been paid. For reasons discussed in the previous section, VAT-type indirect taxes have much less distorting impact than cascading excise and sales taxes, which among other things, can create substantial differences in nominal and effective protection even when tariffs are reasonably uniform. The following sections summarize the extent to which domestic taxes including VATs have replaced protective tariffs in each of the South Asian countries.

India. The story of what has happened in India is apparent from Table 3.20-21 and Figs 3.13-14.

- As already discussed, the tariff collection rate on total imports declined from its high of about 50 percent in 1988, to about 12.3 percent in 2002. The rate of decline slowed for a while in the late 1990s, but dropped sharply from around 17.5 percent in 2001 to 12.3 percent in 2002.
- Correspondingly, the share of tariff revenue in GDP has steadily declined from about 3.5 percent in 1988 to 1.8 percent in 2001 (Table 3.20), with a further decline likely to have occurred in 2002. This waning has, however, been proportionately less than the fall in the tariff collection rate because, since 1988 the share of imports in GDP has increased 57 percent -- from around 7 percent in 1988 to 11 percent in 2001.

- The total tax collection rate from imports (tariffs plus domestic indirect taxes on imports as a percentage of imports) has declined less than the tariff collection rate alone, from around 60 percent in 1988 to 19 percent in 2002. This is because of the increased share of domestic indirect taxes in total tax receipts from imports (in 2002 a bit above one-third, compared to about 17 percent in 1988.) Altogether, total import taxes in 2001 were 2.7 percent of GDP, of which 0.88 percent was from domestic indirect taxes on imports and 1.8 percent from protective tariffs.
- From 1988 until 1999, indirect taxes on domestic transactions (mainly central government excise taxes and central and state sales taxes) declined by much more in relation to GDP than tariff revenues. However, there was a sharp turnaround between 1999 and 2001, a two-year period when domestic indirect tax revenue increased by about 1.5 percent of GDP.
- Until this happened, the only offsets to declining revenues from tariffs and even more from indirect taxes on domestic transactions were increasing revenues from direct taxes, principally corporation taxes and personal income taxes. These remained flat in relation to GDP until 1991, but from then until 2001 they increased by almost 2 percent of GDP. Domestic indirect taxes on imports also made a small positive contribution after 1995.

To summarize, by any international standard, Indian tariffs actually collected reached almost astronomical levels in relation to imports in the mid-1980s. As noted previously, these very high collection rates are best interpreted as the partial transfer of economic rents from the beneficiaries of import licenses to the government. Following the abolition of import licensing on most manufactured intermediates and capital goods in 1991/92 and the steady reduction of import duties until about 1997, the contribution of import duties to government revenues (as measured by their share of GDP) steadily declined. From the mid-1980s efforts were made to simplify and generally clean up the indirect tax system, starting with the introduction of a "modified" VAT ("Modvat"), the scope of which was gradually broadened during the 1990s. But until 2000, instead of compensating for the revenue losses from lower tariffs, the total contribution of indirect taxes (which include state and central government sales taxes as well as the new central VAT-type taxes) to government revenues actually declined in relation to GDP by more than the decline in revenue from tariffs. Even though revenue from direct taxes (mainly corporate and personal income taxes) increased over the period, the net result was a big decrease in total tax revenue in relation to GDP after 1988, from around 18 percent then to 14.6 percent in 1999. After 1999, however, the contribution from domestic indirect taxes and direct taxes increased quite sharply, by about 2.5 percent of GDP over two years. This development suggests that further substantial tariff reductions over the next few years (such as the reduction to a general maximum of 20 percent forecast in the 2002-03 budget speech, or preferably to lower levels) would be easily fiscally sustainable, especially when allowance is made for the likely increase in imports in relation to GDP.

Pakistan. The steep and steady decline in tariffs and in the tariff collection rate in Pakistan during the 1990s (Table 3.22) was accompanied by a correspondingly steep decline in the contribution of tariffs to indirect tax revenue (Fig 3.16), from about 46 percent to only 15 percent in 2001/02. These tariff cuts were not offset by increases in the share of imports in GDP, which stayed within a range of about 16% to 19% of GDP. Consequently, tariff revenue as a share of GDP also fell by more than half, from around 4 ½ percent in the early 1990s to 1.73 percent in 2001/02. However, revenue from the VAT-style sales tax on imports went up as revenue from tariffs went down. From 1999/2000 onwards, it exceeded tariff revenue (Fig 3.16). The combined contribution of the tariffs and the sales tax on imports to total indirect taxes consequently declined only slightly over the period up to 2000/01. Nonetheless, the extent to which government revenue continues to rely on taxes on imports is a cause for concern. In 2000/01 tariffs plus sales taxes on imports accounted for 34.4% of total government (central and provincial) tax revenue and 49.1% of total indirect tax revenue, and the sales tax on imports accounted for 57.7% of total sales tax revenue, having risen from around 45% in 1990/91 (Fig 3.18). If, as appears, sales tax collection in the domestic economy is less comprehensive and rigorous than on imports, the sales tax

would not be operating as intended as a protection-neutral VAT, but to an unknown and probably haphazard extent as another protective import tax. The possibility that a substantial part of the apparent tariff reduction in Pakistan during the 1990s has been spurious would be worth investigating. It might help explain, among other things, the lack of response of the import/GDP ratio to the big decline in tariff rates during the period.

Bangladesh. As noted previously, tariff collection rates in Bangladesh came down in the first half of the 1990s, but new protective taxes brought the decline to a halt from 1998/99 onwards. Consequently the contribution of Customs duties plus the protective taxes to government revenue came down only slightly after 1991/92 (Table 3.23) and then stabilized at high levels, in 2001/01 at 27.5% of total central government revenue and 36.1% of total indirect taxes (Table 3.23-24). As in Pakistan, the tariff reductions had practically no impact on import/GDP ratios (Fig 3.20). If anything, imports for the domestic market (as distinct from duty exempt export-related imports) declined very slightly as a share of GDP. The estimates of protective import taxes in Bangladesh include the component of VAT receipts from imports from which domestic production is formally exempt (e.g. textile fabrics). The remainder in principle non-protective component of VAT on imports currently accounts for about one third of total tax collections from imports. Altogether, total tax collections from imports between 1997/98 and 2000/01 accounted for about 56-58 percent of total indirect tax receipts, only slightly lower than the share (62.3%) in 1991/92. This is a disturbingly high level and, as in Pakistan, suggests the possibility that incomplete VAT collection from domestic transactions in import-competing tradable goods (apart from and in addition to formal VAT exemptions) may mean that the VAT on imports is also acting as an import barrier, over and above the explicit protective taxes. Some research on this aspect of domestic and import tax administration would be useful.

Sri Lanka. The contribution of import duties to government revenue increased in Sri Lanka in the early trade liberalization period after 1978, as QRs were removed and replaced by tariffs and later in the 1980s as export taxes on plantation crop exports were replaced and eventually abolished. The decline in import collection rates that started in 1989/90 was accompanied by long-term decline in the contribution of tariffs to indirect taxes and total taxes, but at a slower rate than the decline in collection rates owing to a steady expansion of imports relative to GDP (Table 3.25 and Figs 3.22-23). As already noted, Sri Lankan public finance is now much less dependent on tariffs than is the case in the other South Asian countries. Even so further reductions might be fiscally difficult unless further expansion of Sri Lanka's already high import/GDP ratio (42.7 % in 1999/2000) could help offset them.

Nepal. In Nepal, tariff collection rates have never been very high. The trade liberalization that brought them down to about 8 percent in the early 1990s initially cut their contribution to government revenues (Table 3.26 and Fig 3.24-26), but this reduction was soon offset by steady expansion in Nepal's import/GDP ratio, which almost doubled between 1990 and 1997. Consequently, Nepal's fiscal reliance on import duties following trade liberalization has remained at about the same high level as during the 1980s. Import duties account for 40-45 % of total indirect taxes, 30-35% of total tax revenue, and around a quarter of total government revenue. It is possible that one reason for the increase in the import/GDP ratio that followed the earlier tariff reductions was diversion of some of the large volume of unrecorded or under-recorded imports into officially recorded channels where import duties were paid. This effect could also mitigate the fiscal effects of further tariff reductions in the future.

Table 3.19
Comparative Import Duty Collection Rates 2000/01

	On total imports	On total imports minus POL	On total minus POL minus export-related
India	17.5	19.7	26.6
Pakistan	10.3	14.6	n.a.
Bangladesh	11.9	10.4	16.7
Sri Lanka (2000)	5.0	n.a.	n.a.
Nepal	10.1	n.a.	n.a.

Data for fiscal 2000/01 except for Sri Lanka which is for 1999/2000. Import duties include other protective taxes as well as Customs duties but exclude indirect taxes such as VAT collected on imports. For details see discussion of individual countries

Fig 3.12
Comparative Import Duty Collection Rates 2000/01

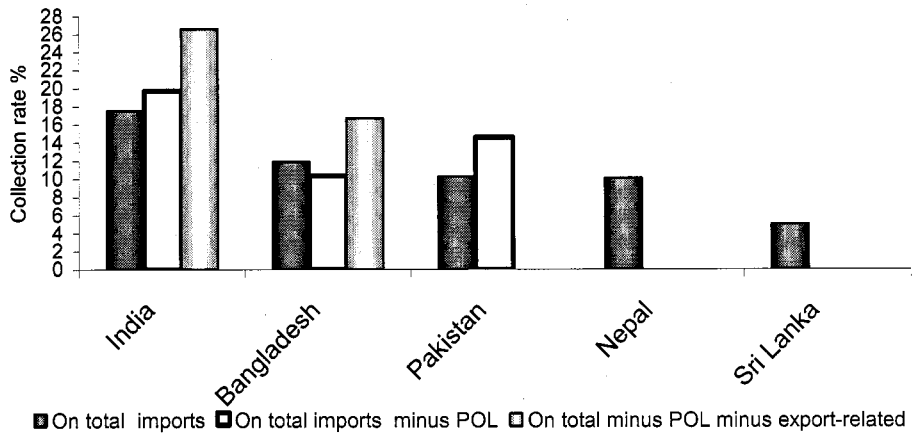


Table 3.20 India 1980-2002

Import Duties And Indirect Taxes On Imports In Relation To Imports, GDP And Total Government Revenue And Taxes

Year	Percent of total imports			% share in GDP of			% share of import duty in			
	Indirect Taxes Imports	Import on Tariffs	Indirect Taxes Tariffs	Imports as % +of GDP	Indirect Taxes Imports	Import on Tariffs	Indirect Taxes Tariffs	Total +Current revenue	Total Taxes	Total Indirect Taxes
1980	8.0	22.0	30.0	8.2	0.65	1.80	2.46			
1981	7.1	18.6	25.7	9.6	0.69	1.79	2.48	9.5	11.8	16.8
1982	7.2	23.0	30.2	8.9	0.64	2.06	2.70			
1983	7.4	27.1	34.5	8.4	0.62	2.28	2.91			
1984	8.6	25.7	34.3	8.0	0.68	2.05	2.73	9.9	12.9	18.2
1985	8.8	31.1	39.9	7.7	0.67	2.40	3.07	11.3	14.9	20.9
1986	7.5	40.2	47.7	7.8	0.58	3.15	3.73	13.8	18.1	25.1
1987	9.6	46.2	55.8	7.2	0.69	3.33	4.03	14.3	18.7	25.8
1988	10.2	50.1	60.2	7.0	0.72	3.53	4.24	15.2	19.6	26.7
1989	9.3	45.7	55.1	7.5	0.70	3.41	4.11	15.1	19.3	26.7
1990	8.7	41.2	49.9	8.1	0.70	3.32	4.03	14.1	18.7	21.9
1991	8.3	39.6	47.9	8.2	0.68	3.27	3.95	15.1	19.0	26.3
1992	7.7	36.3	44.0	8.1	0.63	2.95	3.57	13.0	16.8	20.1
1993	7.7	29.0	36.7	9.4	0.72	2.73	3.46	12.0	16.1	19.4
1994	5.3	24.5	29.8	9.4	0.50	2.29	2.79	10.6	14.7	18.0
1995	7.2	22.6	29.8	9.6	0.69	2.16	2.85	9.8	13.4	20.3
1996	8.7	20.7	29.4	11.2	0.97	2.31	3.28	10.3	14.2	22.2
1997	11.6	20.0	31.7	10.9	1.27	2.18	3.45	10.7	13.6	20.8
1998	9.6	18.5	28.1	10.2	0.99	1.89	2.88	9.4	12.3	19.7
1999	9.4	17.5	26.9	9.8	0.92	1.72	2.65	9.0	11.8	19.2
2000	8.6	16.3	24.8	11.1	0.95	1.81	2.76	8.9	11.5	19.0
2001	7.9	17.5	25.4	10.9	0.88	1.63	2.51	7.3	9.5	15.9
2002	6.7	12.3	19.0							

Notes and sources: (1) Total revenue from tariffs and indirect taxes on imports is published annually in the Indian budget papers and in the Economic Survey. However, until fiscal 2001-02, this series (described as in the Economic Survey as tax revenue from "Customs") did not distinguish revenue from protective customs duties and domestic taxes on imports and gave the total of both of them only. At various times the principal domestic taxes on imports have been called "countervailing duties" or "additional duties" and at present constitute the import component of the general central VAT tax system. In principle, domestic taxes applied to imports do not protect local producers from import competition since they are applied at the same rates to domestic producers of the same products. Hence import tax collection ratios calculated from the published GOI import tax numbers overstate the protective effect of import duties. We have separated out tariff revenue and domestic indirect taxes on imports for 1961-2001 in a separate exercise using a detailed annual publication of DGCI&S (various years).The required data was not available for some years during this period, however, and for those years the division between import duties and domestic taxes was assumed to be the same as the average of the few preceding years. In this table the estimates for which the breakdown was made in this way are indicated in italics. For 1987-92 import duties were assumed to be 82 percent of total import taxes, and 59 percent of total import taxes during 1998-2000. In 2001 they were assumed to be the same as the actual percentage in 2002 i.e. 65 percent. (2) Total government revenue and taxes are the consolidated net revenue and taxes of the central government, state governments and union territories as published annually in the Economic Survey. Total current government revenue includes the internal resources of public sector firms i.e. current revenue minus current outlay.

Table 3.21 INDIA 1981-2001

Revenue from taxes as percent of GDP

	Protective Import Duties	Indirect Taxes on Imports	Indirect Taxes Domestic Services	Taxes Goods	onDirect Taxes (corp., &personal income other)	&Total Taxes
1981	1.79	0.69	8.21		4.55	15.24
1982	n.a.	n.a.	n.a.		n.a.	n.a.
1983	n.a.	n.a.	n.a.		n.a.	n.a.
1984	2.05	0.68	8.51		4.64	15.88
1985	2.40	0.67	8.39		4.62	16.08
1986	3.15	0.58	8.78		4.83	17.34
1987	3.33	0.69	8.88		4.89	17.80
1988	3.53	0.72	8.97		4.82	18.03
1989	3.41	0.70	8.66		4.92	17.68
1990	3.32	0.70	8.78		4.93	17.74
1991	3.27	0.68	8.46		4.76	17.17
1992	2.95	0.63	8.64		5.31	17.52
1993	2.73	0.72	8.23		5.28	16.96
1994	2.29	0.50	7.69		5.12	15.61
1995	2.16	0.69	7.76		5.51	16.12
1996	2.31	0.97	7.12		5.93	16.33
1997	2.18	1.27	7.01		5.63	16.09
1998	1.89	0.99	6.74		5.71	15.33
1999	1.72	0.92	6.32		5.61	14.58
2000	1.81	0.95	6.76		6.19	15.71
2001	1.81	0.95	7.77		6.65	17.17

Fig. 3.13 India 1994-2002
Estimated Tariff Collection Rates

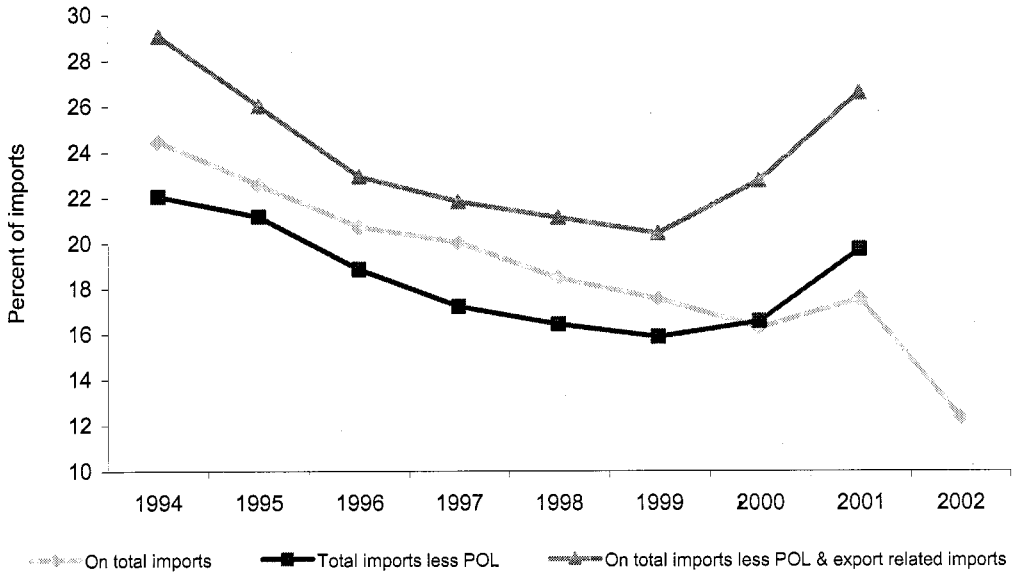


Fig. 3.14 India 1980-2002
Estimated Tariff Collection Rates

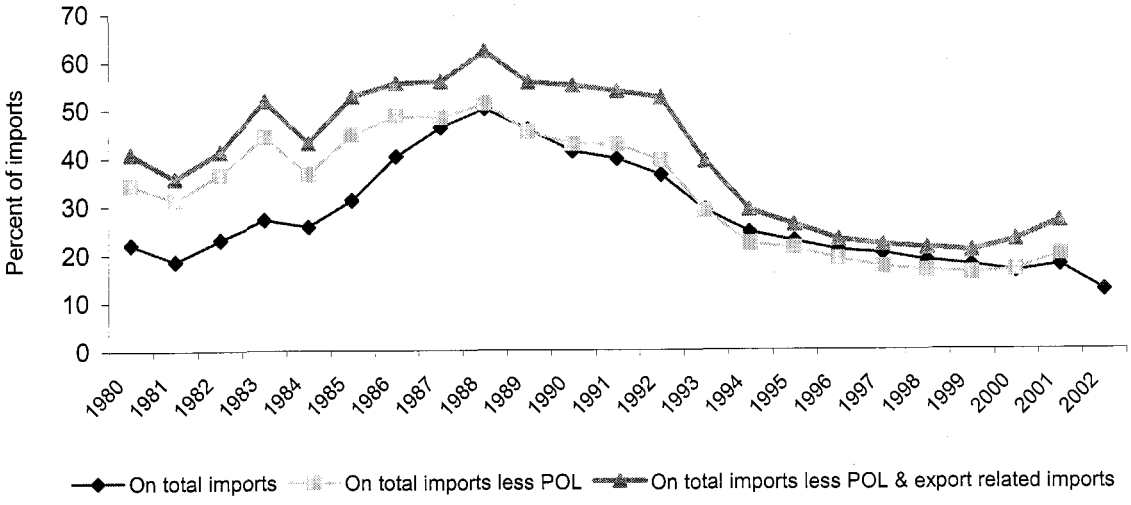


Fig. 3.15 Pakistan
Tariffs and Sales Taxes Collected on Imports, 1991-2001

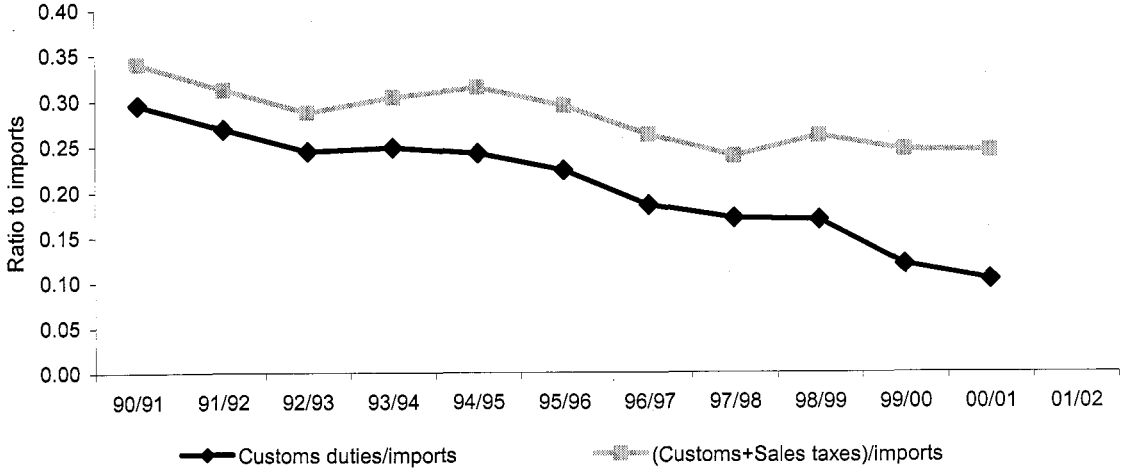


Table 3.22 Pakistan 1990/91-2001/02: Import Tax Collection Rates And Government Revenue

Rs billion	90/91	91/92	92/93	93/94	94/95	95/96	96/97	97/98	98/99	99/00	00/01	01/02
Total imports	171.1	229.9	258.6	258.3	320.9	397.6	465.0	436.3	466.0	533.8	627.0	
Imports of duty exempt intermediate inputs for exporters (& imports s.t. drawback)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	
Imports of POL (Petroleum, oil & lubricants)	37.8	34.4	40.1	42.2	49.0	67.3	88.4	67.5	68.9	145.2	195.6	
Total imports minus POL imports	133.3	195.5	218.6	216.1	271.9	330.2	376.6	368.8	397.1	388.6	431.4	
Total customs duties collected (net after refunds and duty drawbacks)	50.5	61.8	63.2	64.2	77.7	88.9	86.1	74.5	78.7	63.9	64.5	50.5
Customs duties collected on POL	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.5	1.3	1.4
Consolidated central & provincial government revenue	163.9	216.6	239.5	270.7	317.9	368.3	384.3	429.5	468.6	536.8	546.4	625.4
Of which total tax revenue	129.6	164.3	178.4	208.4	257.9	305.6	324.6	354.8	390.7	405.8	444.8	486.1
Of which domestic indirect taxes	58.4	72.7	77.4	99.6	117.1	136.6	151.5	175.2	206.4	229.4	247.0	286.9
Total indirect taxes	108.9	134.5	140.6	163.8	194.8	225.5	237.6	249.7	285.1	293.3	311.5	337.4
Total income and other non-indirect taxes	20.7	29.8	37.8	44.6	63.1	80.1	87	105.1	105.6	112.5	133.3	148.7
Of which (income) withholding taxes on imports	2.1	3.0	3.6	3.8	4.2	10.9	12.6	12.0	14.1	14.7	19.4	19.2
GDP Rs billion		1205.0	1333.0	1561.0	1866.0	2120.0	2428.0	2677.0	2938.0	3147.0	3416.0	3727.0
Imports/GDP %		19.1	19.4	16.5	17.2	18.8	19.2	16.3	15.9	17.0	18.4	
Customs duty collections /GDP %		4.19	4.64	4.05	3.44	3.66	3.66	3.22	2.54	2.50	1.87	1.73
Sales tax on imports	7.8	10.0	11.1	14.3	23.3	28.1	35.9	29.7	43.0	67.3	88.6	83.7
Domestic sales tax	9.2	10.8	12.5	16.1	20.3	21.8	19.8	24.2	29.1	49.5	65.0	61.7
Total sales tax	17.0	20.8	23.5	30.4	43.6	49.8	55.7	53.9	72.1	116.7	153.6	145.4
Customs duties/total imports	0.295	0.269	0.244	0.249	0.242	0.224	0.185	0.171	0.169	0.120	0.103	
Customs duties/total indirect taxes	0.464	0.460	0.450	0.392	0.399	0.394	0.362	0.298	0.276	0.218	0.207	0.150
Customs duties/total tax revenue	0.390	0.376	0.354	0.308	0.301	0.291	0.265	0.210	0.201	0.157	0.145	0.104
Customs duties/consolidated govt revenue	0.308	0.285	0.264	0.237	0.244	0.241	0.224	0.173	0.168	0.119	0.118	0.081
Customs duties minus customs duties on POL	50.5	61.8	63.2	64.2	77.7	88.9	86.1	74.5	78.7	62.4	63.2	49.1
Customs duties excl POL /total imports minus POL	0.379	0.316	0.289	0.297	0.286	0.269	0.229	0.202	0.198	0.161	0.146	
(Customs duties+sales taxes on imports)/imports	0.341	0.312	0.287	0.304	0.314	0.294	0.262	0.239	0.261	0.246	0.244	
(Customs +sales taxes on imports)/total taxes	0.450	0.437	0.416	0.377	0.391	0.383	0.376	0.294	0.312	0.323	0.344	0.276
Customs+sales taxes on imports/total ind taxes	0.536	0.534	0.528	0.480	0.518	0.519	0.513	0.417	0.427	0.447	0.491	0.398
Sales tax on imports/total sales taxes	0.458	0.479	0.470	0.471	0.534	0.564	0.645	0.551	0.596	0.576	0.577	0.575
Sales taxes on imports/total indirect taxes	0.072	0.074	0.079	0.087	0.119	0.125	0.151	0.119	0.151	0.229	0.284	0.248
(Income) withholding taxes/total imports	0.012	0.013	0.014	0.015	0.013	0.027	0.027	0.028	0.030	0.028	0.031	
(Customs+sales+withholding taxes)/total imports	0.353	0.326	0.301	0.319	0.328	0.322	0.289	0.266	0.291	0.273	0.275	

Sources: WB staff estimates from data in Pakistan Economic Survey and data supplied by Central Board of Revenue

Fig. 3.16 Pakistan 1990/91-2001/02
Customs Duties and Sales Taxes on Imports as Shares of Total Indirect Tax Revenue

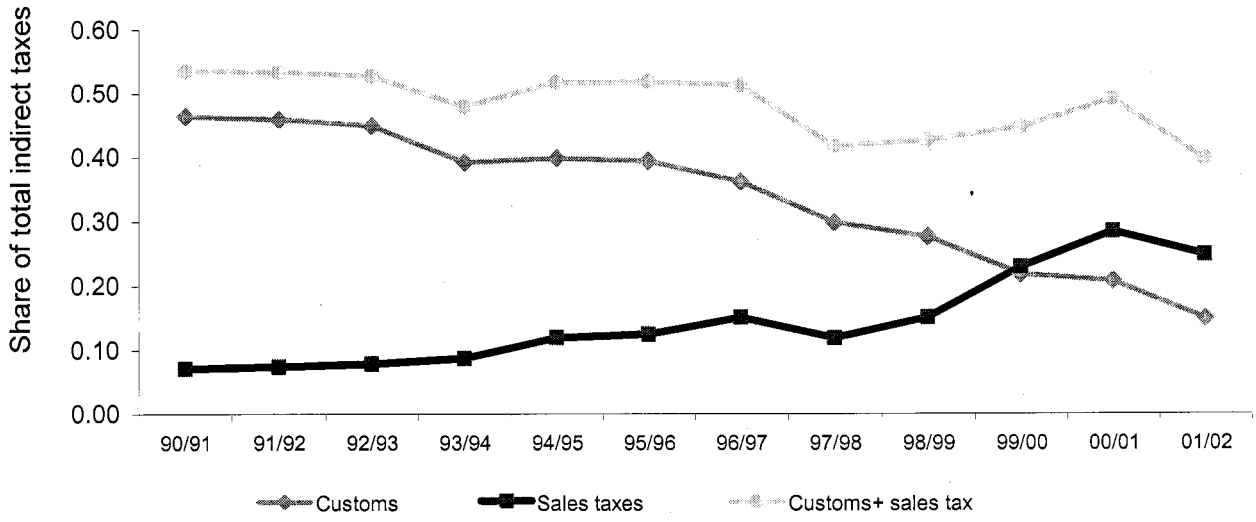


Fig. 3.17 Pakistan 1990/91-2001/02
Tariff Collection Rates: Total and excluding POL

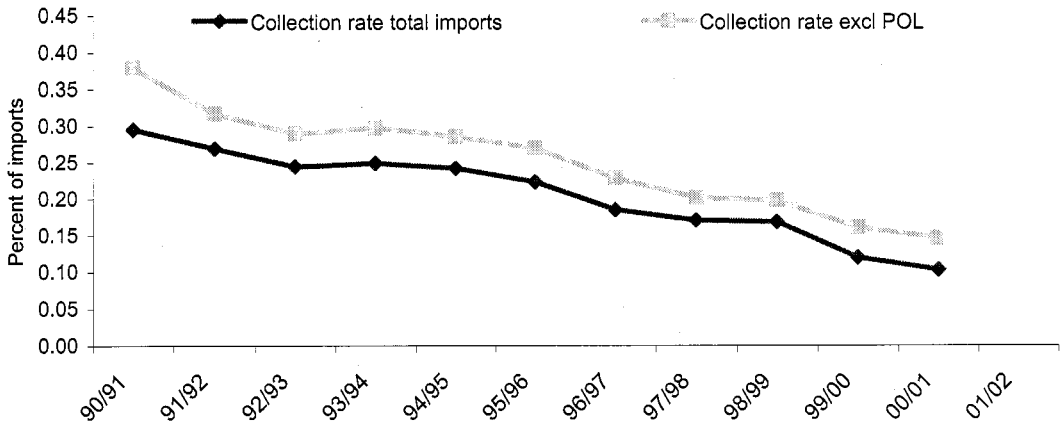


Fig. 3.18 Pakistan 1990/01 -2001/02
Share of Sales Taxes on Imports to Total Sales Taxes and to Total Indirect Taxes

Fig. 3.19 Pakistan 1990/91-2001/02
Shares of Imports and Customs Collections in GDP

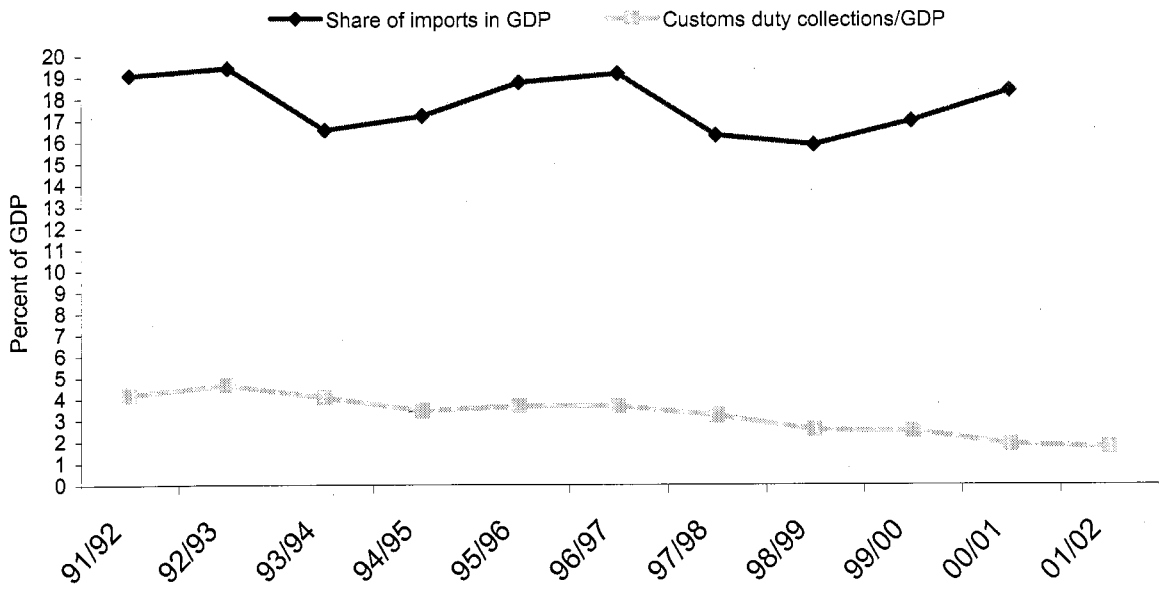


Table 3.23 Bangladesh 1991/92 and 1997/98-2000/01: Protective Import Tax Collection Rates

	1991/92	1997/98	1998/99	1999/000	2000/01
Imports Tk million					
Total imports	132120	340789	369089	397983	450949
POL imports	15364	23041	24766	26684	27633
Duty exempt imports for exporters	30827	116322	112254	140781	160241
Total imports minus POL	116756	317748	344323	371299	423315
Total minus POL minus export related	85929	201426	232069	230518	263075
Import taxes Tk million					
Total protective import taxes (PIT)	26,177	46,464	45,464	46,881	53,604
POL Customs duties	2816	9674	9555	9374	9656
PIT minus POL Customs duties	23,361	36,790	35,909	37,507	43,948
Protective import tax collection rates %					
On total imports	19.8	13.6	12.3	11.8	11.9
On total imports minus POL	20.0	11.6	10.4	10.1	10.4
On total imports minus POL minus export related imports	27.2	18.3	15.5	16.3	16.7

Sources and notes: The estimates in this table have been synthesized from various sources by Bank staff. The principal sources used were: Economic Survey, various years; Maxwell Stamp 2002. Review of Relative Protection; World Bank 1999; Bangladesh Trade Liberalization: Its Pace and Impacts; and data kindly supplied by the National Board of Revenue (trade database), the Bangladesh Bank Statistics Department, and the Bangladesh Export Processing Zones Authority.

Fig 3.20
Bangladesh 1991/92 and 1996/97-2000/01: Tariff Collection Rates

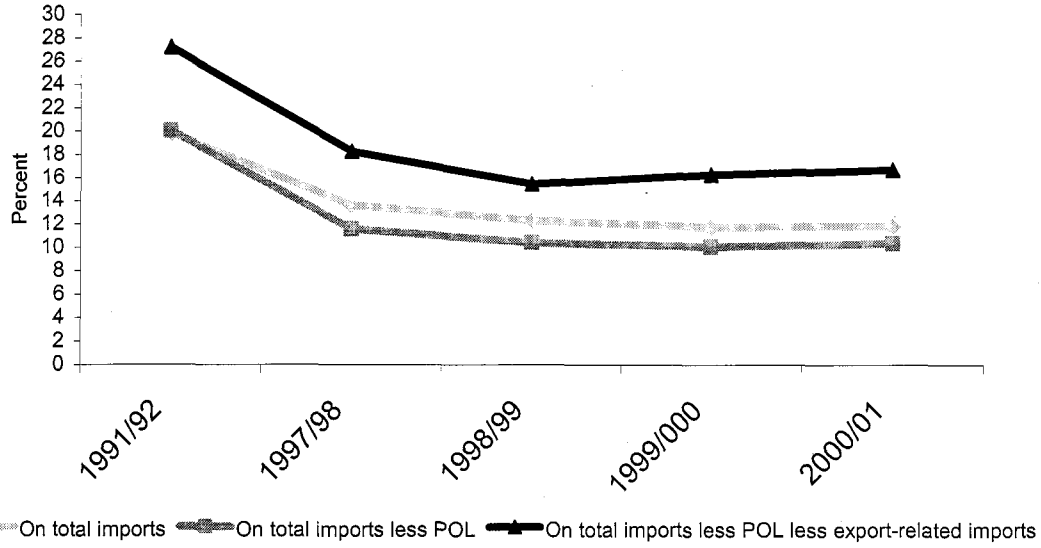


Table 3.24
Bangladesh 1991/92 and 1997/98-2000/01: Protective Import Taxes and Government Revenue

	1991/92	1997/98	1998/99	1999/2000	2000/01
Tk million					
Total Central government tax revenue	78234	150010	158550	170960	194900
Total indirect taxes	59601	128559	126364	131297	148514
Total estimated protective import taxes	26177	46464	45464	46881	53604
GDP at factor cost (current Taka, billion)	849	2001	2196	2371	2581
Protective import taxes as % of					
Total central government tax revenue	33.5	31.0	28.7	27.4	27.5
Total indirect taxes	43.9	36.1	36.0	35.7	36.1
GDP	3.08	2.32	2.07	1.98	2.08
Total VAT on imports	11581	27450	27245	30598	32537
Estimated protective VAT on imports	627	567	436	899	2,085
Residual: "non-protective VAT" on imports	10954	26883	26809	29699	30452
Import taxes as % of total indirect taxes					
Non-protective VAT on imports	18.4	20.9	21.2	22.6	20.5
Protective import taxes	43.9	36.1	36.0	35.7	36.1
Total import taxes	62.3	57.1	57.2	58.3	56.6
Share of Imports in GDP					
Total Imports	15.6	17.0	16.8	16.8	17.5
Imports for domestic consumption	11.9	11.6	11.9	11.1	11.5
Export- related imports	3.6	5.4	4.9	5.7	6.0

Fig 3.21
Bangladesh 1991/92 and 1997/98-2000/01: Shares of Imports in GDP

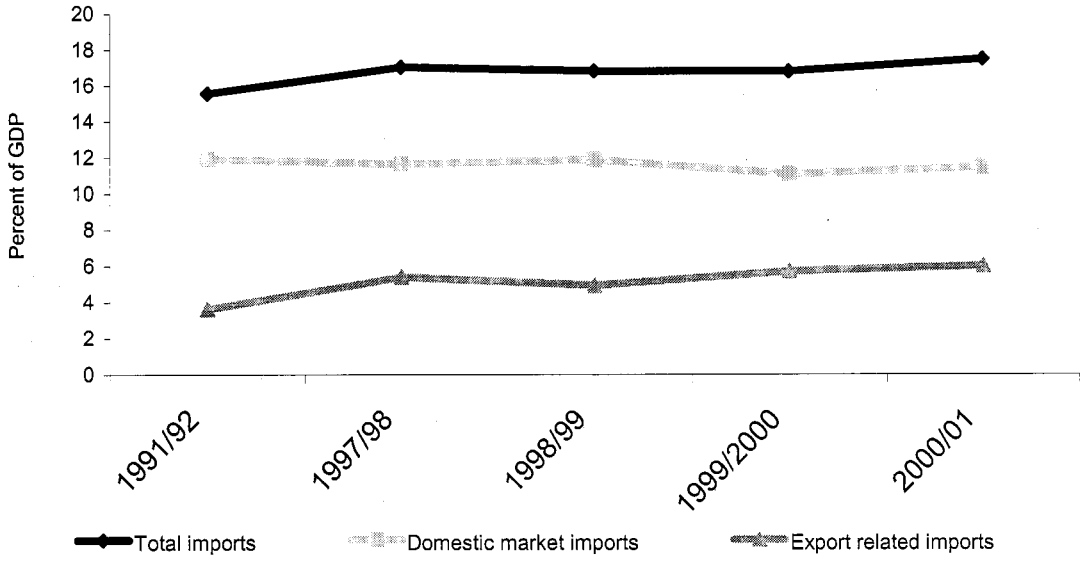


Table 3.25
Sri Lanka 1981-2000: Import Duties and Government Revenue

	Percent of GDP		Import duties as percent of				
	Imports	Import Duties	Imports	Total Revenue	Govt. Total Revenue	Tax Revenue	Total Indirect Tax Revenue
1981				18.2	19.7	23.7	
1982			6.8	15.4	17.0	21.9	
1983			9.5	17.2	20.1	24.8	
1984			14.3	19.7	22.4	27.9	
1985			16.5	22.4	26.6	33.2	
1986			18.3	25.3	30.0	36.4	
1987			18.6	26.4	31.6	38.7	
1988			15.2	25.7	29.8	36.3	
1989			19.8	27.6	31.4	37.5	
1990			15.9	24.9	27.5	33.1	
1991			14.6	24.3	27.3	33.9	
1992			13.9	24.2	27.2	33.7	
1993	36.3	4.12	11.4	20.9	23.6	29.3	
1994	38.3	3.90	10.2	20.5	22.7	28.3	
1995	36.9	3.69	10.0	17.9	20.6	25.4	
1996	36.0	3.31	9.2	17.4	19.6	24.5	
1997	41.4	3.32	8.0	16.2	18.7	23.3	
1998	40.4	3.09	7.6	16.1	19.1	23.5	
1999	38.1	2.78	7.3	14.1	16.7	21.3	
2000	42.7	2.15	5.0	11.4	13.2	16.3	

Fig 3.22
Sri Lanka: Shares of Imports and Import Duties in GDP

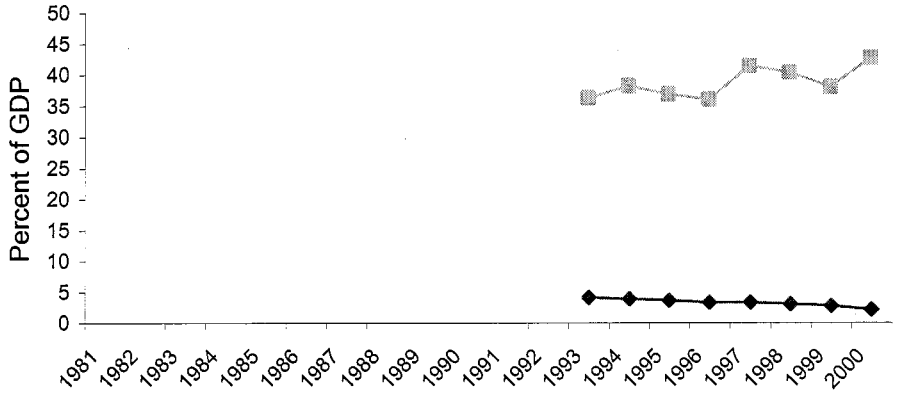


Fig 3.23 Sri Lanka
Import Duty Collection Rate and Import Duty Shares of Government Revenue

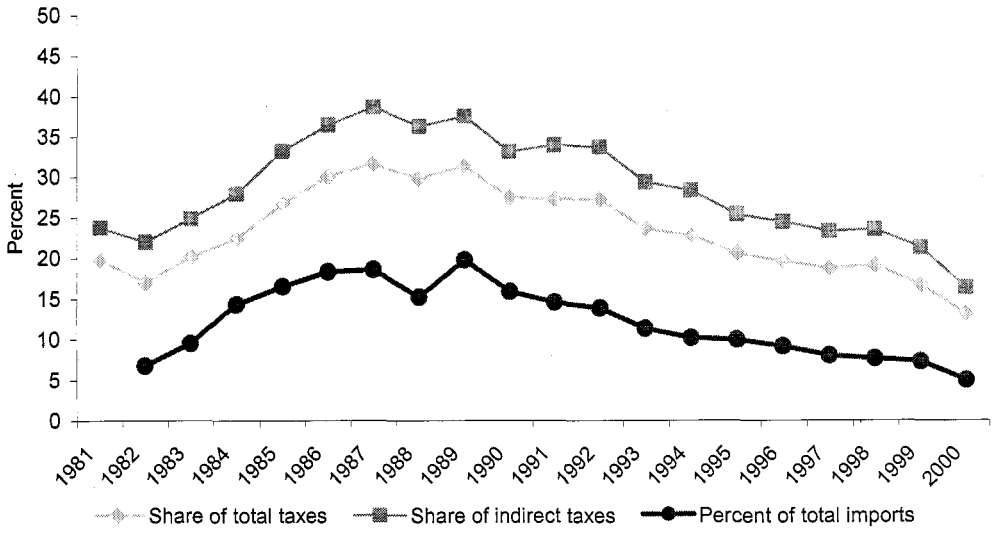


Table 3.26 Nepal: Import Duties and Government Revenue 1985-2001

	Percent of GDP		Import Duties as Percentage of						
	Imports	Import duties	Imports	Total Govt	Total Tax	Total Indirect	Indian VAT Refunds	Import Duties + Indian VAT Refunds	
1985	16.62	2.16	11.7	31.5	32.0	38.7	1.3	13.0	
1986	16.76	2.07	11.6	24.9	31.6	38.3	0.8	12.4	
1987	17.08	2.23	11.8	23.8	32.5	39.2	1.3	13.0	
1988	18.04	2.74	14.3	28.9	36.6	44.1	0.9	15.2	
1989	18.22	2.49	13.1	28.6	35.4	44.6	0.6	13.7	
1990	17.72	2.56	14.4	28.5	36.3	45.0	0.0	14.4	
1991	19.30	2.46	11.9	27.6	36.3	43.4	0.9	12.8	
1992	21.37	2.17	8.8	24.0	32.8	38.9	1.4	10.2	
1993	22.86	2.22	8.1	25.1	32.6	38.9	1.6	9.7	
1994	25.88	2.42	8.4	24.6	31.3	37.9	0.9	9.3	
1995	28.92	3.03	9.2	27.2	34.0	42.1	1.3	10.5	
1996	29.78	2.86	8.4	25.6	33.0	41.9	1.2	9.6	
1997	33.33	2.89	7.6	26.7	33.2	42.3	1.1	8.7	
1998	29.58	2.75	8.0	25.1	31.9	41.6	1.3	9.3	
1999	25.58	2.67	9.0	24.5	31.7	42.5	1.4	10.4	
2000	28.58	2.72	8.3	24.1	31.2	42.0	1.2	9.5	
2001	28.26	2.95	9.2	24.7	31.0	41.4	1.3	10.4	

Sources: Nepal Rastra Bank, Quarterly Economic Bulletin, Mid-January ,2002. Vol. XXXVI, no 1&2, and World Bank (2002) Nepal Development Forum, Economic Update 2002. January 30,2002. World Bank. SIMA database.

Fig 3.24
Nepal 1985-2001: Import and Import Duty Shares in GDP

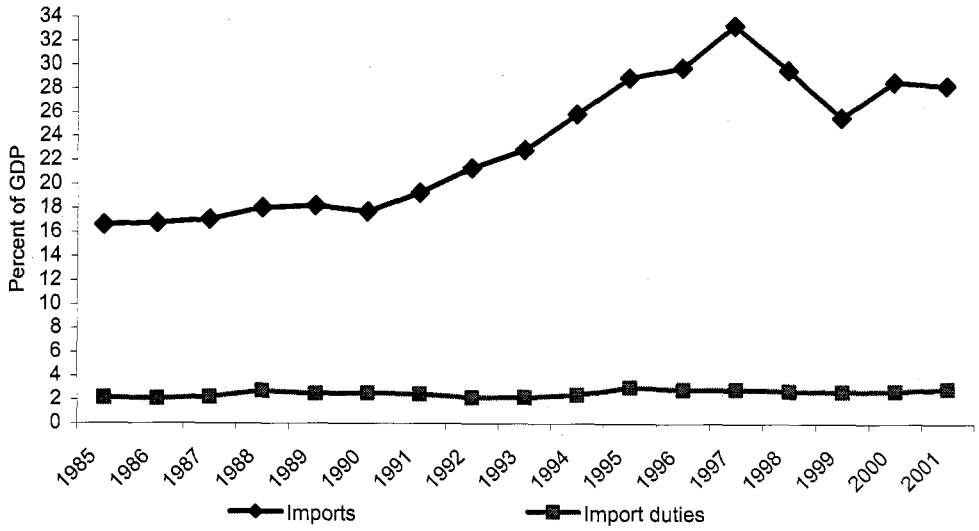


Fig 3.25
Nepal Import Tariff Collection Rates 1985-2001

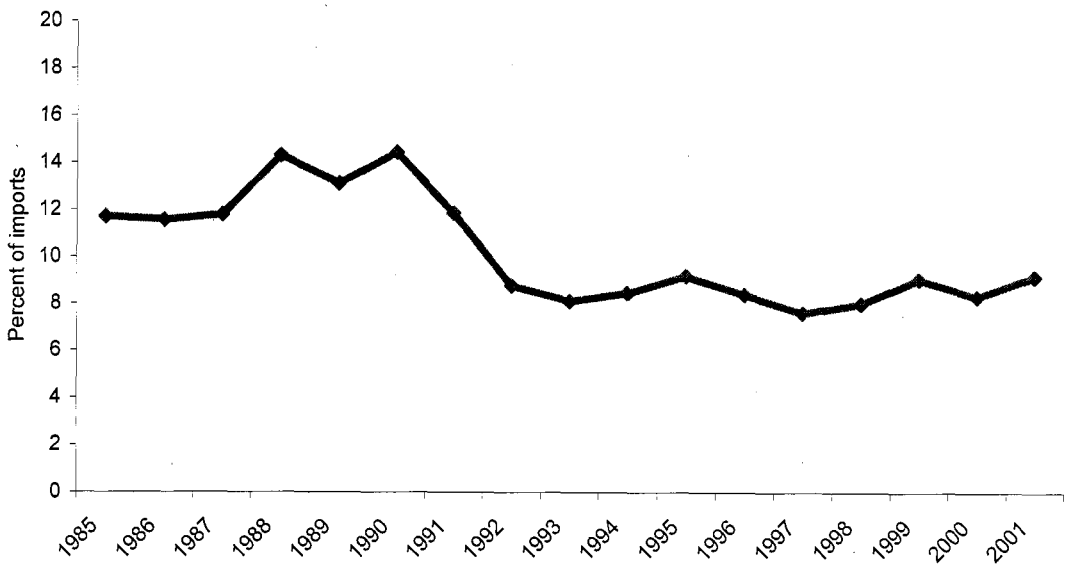


Fig 3.26
Nepal 1985-2001: Shares of Import Duties in Government Revenue

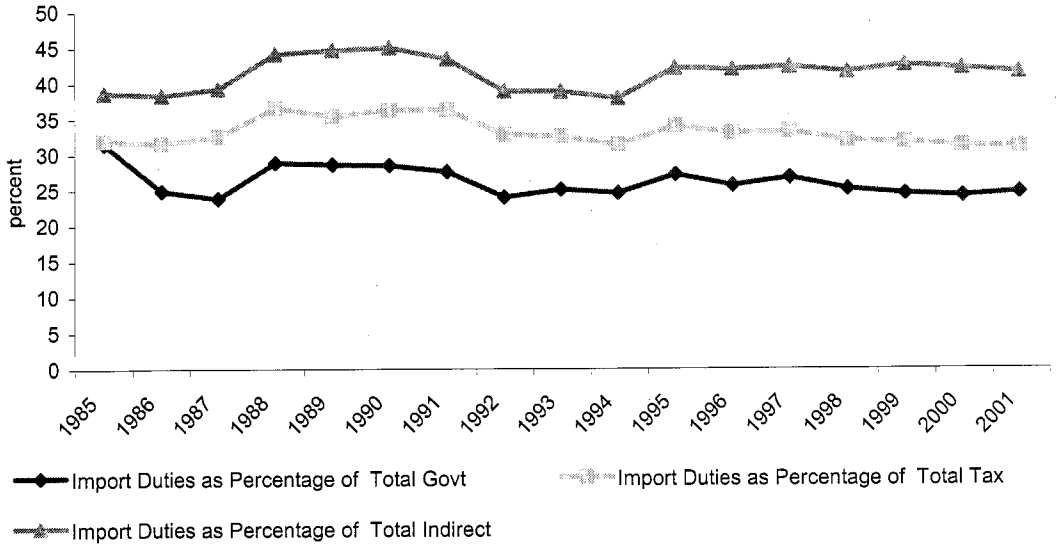


Table 3.27 : Comparative Collection Rates

	Imports/ GDP %	Total import duty revenue as percent of:				
		GDP	Imports	Total govt. Revenue	Total taxes	Indirect taxes
India 2001	10.9	1.81	17.5	7.3	9.5	15.9
Pakistan 2001	14.7	1.87	10.3	11.8	14.5	20.7
Bangladesh 2001	17.5	2.08	11.9	22.2	27.5	36.1
Sri Lanka 2000	42.7	2.15	5.0	11.4	13.2	16.3
Nepal 2001	28.3	2.95	9.2	24.7	31.0	41.4
China 1998	14.5	0.39	2.7	3.1	3.4	4.2
China 2001	21.0	0.60	2.7			

Fig 3.27
South Asia and China
Import Duty Collection Rates

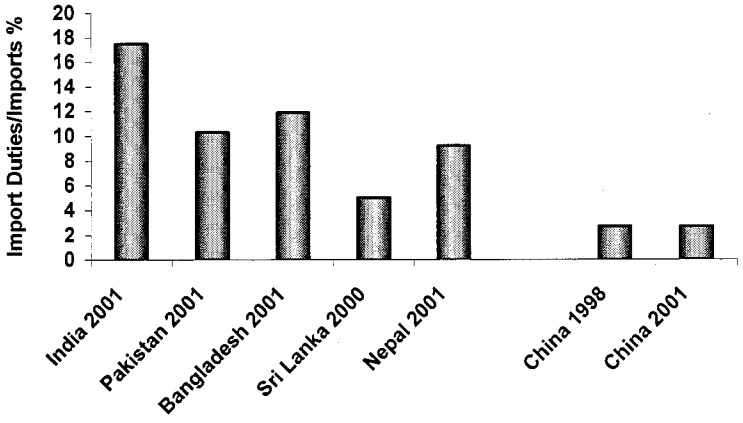


Fig 3.28
South Asia and China
Import Duty Revenue as percent of GDP

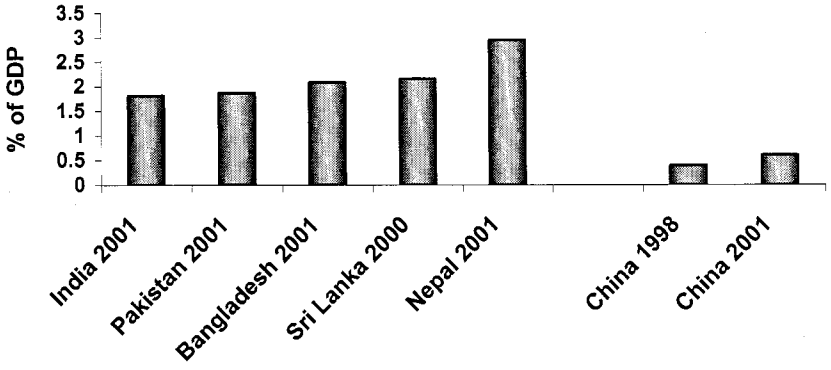


Fig 3.29
South Asia and China
Imports as Percent of GDP

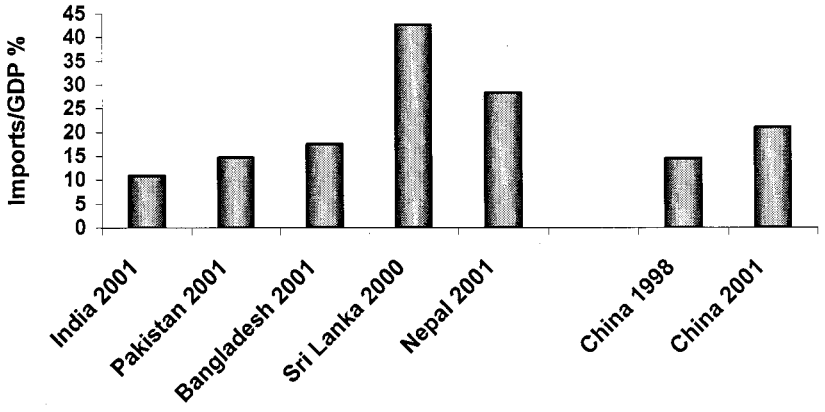
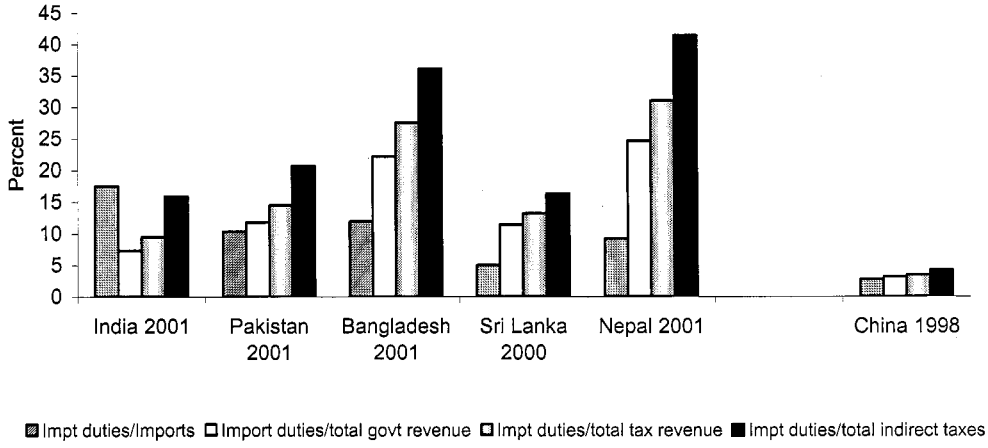


Fig 3.30
South Asia and China
Import Duties in Relation to Imports and Government Revenue



Chapter 4: Export Policies

Export policies during the import substitution period

During the early years when the dominating objective of trade policies was to substitute for imports behind non-tariff barriers and very high tariffs, all the South Asian countries developed systems of varying complexities and comprehensiveness which aimed to enable exporters to function profitably in this environment. Even though exports were given very low priority, they were needed to earn foreign exchange to pay for imports that were not being produced domestically or not in sufficient quantity, and for other outlays in foreign exchange such as debt service, travel, technology imports, insurance, shipping etc.

The various schemes that were developed had two principal objectives. The first was to make available to exporters needed inputs that could otherwise not be imported at all, or only after difficult and time consuming efforts to obtain a normal import license. The second objective was to eliminate or offset the cost raising effects of NTBs of various kinds and of tariffs and domestic taxes, on the cost of inputs used by exporters. Given the stringency of import licensing and other non-tariff barriers to imports, and the high tariffs that prevailed, with some exceptions, it would have been impossible to export most products without these schemes. The principal exceptions were primary commodities exported in bulk or in forms which did not require many importable inputs.

An indication of the low priority attached to exports in general and to primary exports in particular, was that many of these products were subject to export restrictions and taxes. Another set of exceptions were some manufactured products (e.g. cotton textile yarns and fabrics in India and Pakistan, jute textiles in Bangladesh) where the domestic prices of the primary inputs were about equal to or below world prices. Exports of some of these manufactured products (e.g. cotton textiles in India and Pakistan) were indirectly subsidized by export controls which suppressed the domestic prices of the raw materials, such as cotton. These measures were principally justified as another form of protection aimed at creating or expanding production and employment in the processing industries.

As well as attempting to offset or neutralize the effects of import policies on the cost of exporters' inputs, some schemes went beyond this and provided export subsidies, in the sense that the processing margins of exporters were increased beyond what they would have been if all their outputs and inputs had been sold and purchased at prevailing world prices. For example, until they were abolished during its 1991 reforms, India provided Cash Compensatory Support (CCS) subsidies to exports which were specified percentages of fob prices, and which were paid even though the import duties on the inputs for the same exports had been exempted by special duty free import licenses or refunded through the duty drawback system[1]. India also used saleable "replenishment" import licenses issued to exporters which gave them the right to import otherwise restricted products many of which sold for high premiums in the domestic market[2]. Export subsidies were also provided, although in a haphazard manner and not always intentionally, through the ways in which the various duty exemption or drawback schemes were administered e.g. as a result of using higher than actual physical input-output ratios or wastage

[1] Indian CCS subsidies during the 1980s are discussed in Pursell (1992). They were justified as compensating for domestic sales and other taxes, but they varied substantially from product to product mainly according to the "needs" of exporters to compete in export markets, and there was no serious attempt to make quantitative links between the varying rates and the incidence of domestic taxes.

[2] For descriptions and analyses of Indian export policies before the 1990s see Bhagwati and Desai (197..), Wolf(197..), and Pursell (1992) and the references given there. Many of these export schemes are still operative under the same names (e.g. advance licenses and duty drawback) of under different names but performing the same or similar functions.

allowances, from overestimation of the prices of imported inputs, from delays in adjusting for declines in imported input prices[3], and from failure to ensure that all duty free imported inputs were actually used in exports.

During this early period, going beyond the neutralization of input protection and providing export subsidies, was motivated in part by the recognition that exports were being discouraged much more generally by the high-protection import substitution regimes that were in place, than simply by the import controls and duties that raised the costs of exporters' imported inputs. This had been clearly articulated very early on by many economists[4], who pointed out that (1) restricting imports necessarily allowed the South Asian countries to equilibrate their current accounts with stronger exchange rates than would have existed with less restrictive import policies, thereby reducing the domestic currency prices of exports (2) even with perfect neutralization of input protection involving no transaction costs, the effective protection of exporters would be zero, compared to generally high effective protection of import substitution industries,

Despite many repetitions of these general principles, and studies which illustrated the points empirically[5], businessmen and bureaucrats involved in the practicalities of trade policies had great difficulty in grasping them. Instead they emphasized the many disadvantages that exporters faced in the South Asian countries, such as high cost and unreliable power supplies, various state and local taxes, poor quality roads, port facilities, telecommunications, banking and other services, and argued for export subsidies that would help offset these disadvantages. They were reluctant to draw the obvious and very simple conclusion, namely that protection against imports is simultaneously a tax on exports, and that the most direct way to reduce the bias against exports is to reduce NTBs and tariffs applied to imports. Apart from the conceptual difficulty of grasping the connections between protection and exchange rates, this reluctance was also a consequence of the vested interests of important segments of the business communities and of the trade policy bureaucracies, in the continuation of protection policies, and similar vested interests on both sides in the continuation of duty neutralization schemes and export subsidies, both of which involved substantial transaction costs and rent-seeking opportunities.

Export policies during import liberalization

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 since the 1960s. This point was underlined, especially in India, when it became apparent during the 1990s that China's example showed that export oriented economic growth was possible and feasible even for very large countries. As noted in the previous chapters, substantive

[3] Most drawback rates are first estimated using data provided by exporters on physical input-output coefficients and the cif prices of the required imported materials, from which is calculated the import duty on the inputs needed for a given quantity (e.g. per kilo or per ton). To simplify administration, the import duty to be refunded is then expressed as percentage of the fob price of the exported product. It is apparent that drawback payments in this system are unlikely to exactly correspond to the actual import duties paid on the imported inputs, and may be substantially higher or lower. They will tend be higher if, compared to the data used to calculate the drawback rate, actual fob prices are higher, input prices are lower, or fewer materials are used, and vice versa. For obvious reasons exporters are not motivated to provide new information if the refunds or duty exemptions they are receiving exceed what is needed to just neutralize the import duties and other taxes on their imported inputs, but are likely to complain if the benefits they receive are inadequate. On the other hand the basic role of Customs services is to collect import duties according to official tariff schedules and rules and to limit the avenues by which they can be evaded. Duty drawback and exemption schemes for exporters are therefore inevitably a major source for negotiation, bargaining and conflict between Customs departments and exporters, the more so when import duties are high.

[4] These basic points were made very clearly and illustrated empirically during the 1960s by Bhagwati, Desai and T.N.Srinivasan.

[5] Most recently in a study completed in 2002 which among other things compares effective protection rates for domestic sales and exports. Maxwell Stamp. 2002.

trade liberalization occurred first in Sri Lanka, came later in Pakistan, Bangladesh and Nepal, and reluctantly and slowly, with hesitations along the way, in India. 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. As regards India, it is significant that as late as January 2002, an official government report on India's Export-Import policies felt it necessary to state the following[6]:

"It is noteworthy that while the reform program has emphasised the need to reduce import protection and to provide a facilitating policy environment for private initiative, the mind-set regarding exports has remained virtually unchanged. Even today, when policy makers address the issue or exports, it is mainly in terms of their contribution to foreign exchange earnings and thus the extent to which they fund our imports. The Committee feels that the Government must re-orient this attitude and recognize the multifaceted contribution of exports to the economy, in terms of developing links with the high productivity and high quality markets abroad, thus providing a basis for improved efficiency at home. In addition to providing a larger market for our domestic production with the attendant benefits of economies of scale, exports contribute importantly to acquisition and dissemination of modern ideas, technology, design, marketing and packaging techniques, and infuse changes in our work ethos that will have a lasting impact on improving our efficiency through, for example, emphasis on modernization, quality and even innovation."

This increased recognition in South Asia of the positive role of exports in economic growth, led to much greater scrutiny 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.
- *Successful exporting, especially to developed country markets, needs special skills and capabilities* that were not generally needed to the same extent in supplying protected domestic markets, including attention to quality and quality reliability, technological and marketing know-how, reliability and speed of delivery, and general operational flexibility. To speed up the development of these skills and capabilities, 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. While the means employed to achieve these objectives were frequently of dubious efficacy (e.g. the establishment of government owned and

[6] Government of India, Department of Commerce, Directorate General of Foreign Trade. January 2002. *Report on the High Level Committee for the Exim Policy 2002-07*, p.3. This is an excellent report which provides a very useful and practical critical review of key aspects of India's current export policies.

bureaucratically managed export promotion organizations and the provision of subsidized export credit), others had positive spillover effects as well as aiding exports.

- *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.

Current export policies

Table 4.1 provides a summary list of most of the principal export-specific policies currently being operated in the South Asian countries, with the exception of the policies affecting textile and garment exports that allocate MFA quotas. They have been 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; (vi) export incentive and promotion schemes tailored for particular products or industries.

Other policies of course also affect exports: in particular exchange rate, labor market and tariff and other protection policies. Bearing this in mind, some general points about the export-specific policies are worth noting.

- Not surprisingly, of the five countries *India has the most comprehensive and complex set of export policies*. This reflects the facts that, 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 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.
- Table 4.2 provides an indication of one key aspect of the current differences between the export policies of the five countries, namely, the *levels and the complexity of tariffs on intermediate inputs with which their exporters and export bureaucracies have to grapple.* It can be seen that present tariffs in Sri Lanka on many key raw material and partly processed industrial inputs are only 2.4%, while all the principal textile tariffs –fibres, yarns and fabrics-are zero. By contrast, tariffs on major raw materials are much higher and also more complex in India and Bangladesh, e.g. for organic chemicals, three different rates with a maximum of 30.8% plus some anti-dumping duties in India, and five different rates ranging from 3.5% to 36% in Bangladesh. This is without allowing for preferential tariffs under SAPTA and other agreements which further expand the number of different rates for the same or related raw materials, and correspondingly increase the administrative tasks involved in implementing mechanisms such as drawback. The differences between Sri Lanka, on the one hand, and India and Bangladesh especially, and to a lesser extent Pakistan and Nepal, are even more marked as regards textiles, where domestic production of wool, cotton and synthetic textiles has been systematically protected by the use of escalated tariff structures. In Sri Lanka free trade in textiles means that no special scheme is needed to exempt or rebate tariffs on textiles imported by

garment exporters: only the VAT on these imports (currently 20%) would need to be credited or rebated as part of the normal VAT accounting settlements in which exports are exempt from VAT[7]. By comparison, in India there are four different ad valorem tariff rates within both the wool and cotton textile HS chapters, plus a large number of compound tariffs where the applicable duty is the higher of an ad valorem rate and a specific duty[8]. Similarly there are two ad valorem rates within the man-made fiber and staple fiber textile HS chapters, plus compound tariffs and also anti-dumping tariffs. The levels of these textile tariffs in India means that it would be impossible or at best very difficult to export while using imported textiles as inputs, unless the tariffs are exempted or rebated, but at the same time the number of different rates for similar products makes this process time consuming and expensive in terms of transaction costs. Other examples are iron and steel materials and partly processed steel and alloy steel products (HS chapter 72), where over 95% of Sri Lanka's tariffs are just 2.4% in contrast to India where over 95% of ad valorem rates are at 30.8%, plus the use of an extensive list of arbitrary "tariff values" (minimum values to which tariffs are applied), plus anti-dumping duties. In this case, in India, exporters wishing to use imported iron or steel products as inputs would also have to contend with highly restrictive technical certification rules for imported steel managed by the Bureau of Indian Standards[9]. Similarly, in Bangladesh, iron and steel tariffs are very escalated, with five rates ranging from 3.5% to 36%. Steel inputs for exporters are also a problem for exporters in Pakistan, where tariffs (5, 10 and 25 percent) have been escalated to protect the public sector firm, Pakistan Steel.

- Table 4.2 also illustrates, however, that *very considerable progress has been made in all the South Asian countries in simplifying and (except in India) reducing machinery and equipment tariffs*. At present most of these tariffs are either 2.4% or 6% in Sri Lanka, 6% in Nepal, 7.5% in Bangladesh, and 5% or 10% in Pakistan. In these four countries, while exemptions and rebates of various kinds are provided for exporters (see Table 4.1) the quite low equipment tariffs mean that even though the exemptions and rebates are useful, they are not generally essential for profitable exporting, and it is probably not worthwhile for firms to incur substantial transaction costs in obtaining them or in lobbying for further reductions or special treatment.

  In India, considerable progress has also been made in simplifying the structure of machinery tariffs, with most (including Customs duties and SAD) now at 30.8%. However in order to protect domestic equipment producers, this rate (which usually also applies to replacement components and parts as well as to original equipment) is very high and is a significant disincentive for exporters. Consequently, since 1990, India has been using an elaborate and administratively very onerous facility (the Export Promotion Capital Goods scheme) under which at present machinery import duties are reduced to 5% in return for the firms satisfying specified export obligations. Since firms can use the equipment to produce for the domestic market as well as for exports, under some conditions the scheme amounts to a cross subsidy of exports by widening the profit margins on domestic sales. In the 2003-04 budget, this scheme was made much more flexible by reducing the export obligation by more than half, by allowing second hand capital goods (previously excluded) to be covered, and by a separate reform which removed restrictions on the resale of imported second hand capital goods[10].

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[7] This would apply to a garment exporter operating outside one of Sri Lanka's EPZs. Garment and other exporters operating in these zones are exempt from VAT as well as import duties.

[8] For a discussion of India's specific textile tariffs and some estimates of their ad valorem incidence see Chapter III in volume 2 of this study.

[9] See discussion in Chapter 2.

[10] These reforms are described by Arun Goyal in "India Trade Notes", BIG's Weekly Index of Changes, Vol XX No 01, 01-07 April, 2003. The reforms reduced the export obligation from 8 times the cif value of the imported equipment to about 3.7 times, were extended to cover imports of second hand equipment, and removed an "actual user" restriction which prevented the resale of the imported equipment. The permission to import second hand capital goods only applies to machines that are less than 10 years old: otherwise a special import license is required. Goyal (ibid) thinks that the new export obligation (8 times the value of the foregone import duties) will be easily met, since import duties on second hand machines are low due to the Customs

According to Goyal[11], these reforms will lead to a substantial opening of the Indian market for capital goods, increased import competition for domestic machinery producers, and lower domestic machinery prices. Such a development would benefit all equipment users including exporters not arranging imports under the EPCG scheme, and is a good example of how pressures from exporters can lead to much more general economic benefits. However, even if this turns out to be the case, slow indirect liberalization of capital goods imports through the EPCG scheme in India contrasts with direct and much more straightforward capital goods liberalization through tariff reductions to low levels in the other South Asian countries. Among other things, it is evident from a glance over the structure and the enforcement and other rules of the EPCG scheme,[12] that it is very much an "inspector Raj" creation with ample opportunities built in for discretion, negotiation and rent-seeking behavior.

- Despite the emphasis on export facilitation and promotion, *a surprisingly large number of products are still subject to restrictive export policies which are in place for "trade" reasons* i.e. that are not intended to ensure that exporters meet importing country SPS requirements or quality standards, and are not for domestic religious, social, environmental and similar reasons. These include export bans and licensing, government export monopolies, and export taxes[13]. Most of the direct controls are in India and Bangladesh[14]: 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, processors of hides and skins, raw wool and logs and timber in Nepal). Some export bans or restrictions have the effect of indirectly subsidizing exports of products further down the production chain.

  For example, Bangladesh's ban on the export of animal hides and skins subsidizes production and exports of processed leather products. Similar export restrictions on unprocessed skins and partially processed leather in India and Pakistan were successfully challenged at the WTO by the EU and have been replaced by export taxes. These also indirectly subsidize processed leather products, but in a more transparent manner[15]. 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. As noted in Chapter 3, the defense tax (imposed to raise revenue to deal with the Maoist insurrection) was also added to import duties, but it would be more efficient economically to levy a general tax on production or consumption rather than providing extra protection to high cost import substitution production while taxing relatively more efficient export production.

  Sri Lanka does not have any export taxes, but appears to be hindering the efficient development of two major export industries, tea and spices, by disallowing imports of tea varieties for blending with local teas, and spices for partial processing and re-export during periods when domestic spices are not

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depreciation rules which provide for the dutiable value to be reduced by about 4% per quarter up to a maximum of 70% of the original value. If this is correct, he points out that foreign suppliers of the machinery might have little difficulty in channeling the required export order to the firm importing it. These exports could be diverted (with some compensation involved) from other Indian firms with established export markets that are not currently in the market for imported equipment.

[11] Ibid

[12] Goyal (*Easy Reference Customs Tariff 2003-04,* pp R/45-68*)* gives the provisions of the EPCG scheme and the many changes in it since 1990.

[13] There are a number of small export "cesses" (generally at less than one percent of fob prices) on particular commodities which have not been included in Table 4.1 as export taxes e.g. in India and Sri Lanka. These are not really export taxes since they are generally ploughed back into the same exporting industry to promote rather than restrict its exports.

[14] The 18 agricutural, livestock, and fisheries products the export of which is either banned or restricted in Bangladesh, is given in the chapter on agriculture in Volume II (Table 1.6)

[15] Subject to one principal exception, export bans and restrictions breach Article 11 of the GATT, but export taxes are *prima facie* GATT compatible, even though countervailing duties could be imposed by countries importing products which use them as inputs on the grounds that the export taxes on the inputs constitute indirect export subsidies.

available. Both of these restrictions appear to be responses to domestic grower lobbies who object to the potential competition and the adjustments that would be required if the imports were allowed[16]. Nepal has a similar restriction on imports of machine spun woolen yarn which protects the hand-spun yarn producers who supply its export carpet industry, but which inhibits the development of woolen carpet exports using imported machine spun yarn[17].

- *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[18]; Bangladesh subsidizes exports of garments which use domestic fabrics[19] and its Export Development Fund provides a number of different subsidies to exporting firms; 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, and together with Nepal they also provide indirect subsidies through export prohibitions, restrictions and taxes applied to raw materials used as inputs for processed products. India also subsidizes exports in a number of non-transparent little-noticed ways, e.g. provisions which benefit export houses, handicrafts, EPZ firms, and provisions in its Export Promotion Capital Goods scheme[20]. Other indirect export subsidies (see Table 4.1) 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.
- *All the South Asian countries are using duty neutralization schemes* to either refund or exempt in advance import duties and other taxes on inputs and machinery used by exporters. It is important to note that it is also necessary to deal with import taxes other than Customs duties, including especially VAT-style indirect taxes. This means that even under free trade with no protective Customs duties or other protective taxes (as is the case for textiles in Sri Lanka) some form of exemption or refund mechanism is needed for exporters. The methods used in South Asia include drawback schemes, various kinds of prior exemption schemes, *ad hoc* exemptions for particular products or exporters, duty exemptions and concessions for equipment and replacement parts, provisions for duty neutralization of inputs used by indirect exporters (i.e. firms supplying intermediate inputs to exporters), rules for the treatment of "deemed exports" (e.g. domestic sales involving competitive

[16] These ostensible reason given for these restrictions is that without them inferior quality teas and spices would be imported and then packaged and exported either in their original state or more likely blended with local varieties. It is argued that this would undermine the special reputation of Sri Lankan teas and spices for quality and reduce the net export returns. This seems a very dubious argument at best, since if there were a premium for unblended purely Sri Lankan products exporters would have a strong motive to make sure that their products were labeled and marketed accordingly. The relevant export trade associations would have a motive to make sure that accurate labeling is observed, and this could be reinforced if necessary with appropriate government regulations. In the case of tea, it is reported that the import ban has contributed to decisions of major tea marketing companies to establish themselves in Dubai and Singapore instead of in Colombo. In these places they import in bulk, blend and market teas from Sri Lanka and elsewhere in bulk.

[17] One reason given for this restriction is that it protects the integrity of the reputation and the export price premium of Nepal's hand-made carpets. As is the case with tea and spices in Sri Lanka, the alleged export price benefits of the restriction are dubious at best, and are probably outweighed by the inhibiting effects of the restriction on the carpet weaving industry: see discussion in World Bank (2003). Chapter 2: In any case it is likely that the restriction is by-passed to some extent by illegal imports via India (textiles are one of the largest items in this informal trade: see Taneja et al, 2002).

[18] For further discussion of these export subsidies see Volume II, Chapter 1.

[19] This subsidy program started in 1997/98 and was originally either at 25% of the value of the domestic fabrics and yarns supplied to the garment exporter, or at 25% of 75% of the value of the garment exports i.e. 18.75% of fob prices. In principle it was not available if the yarn or fabric supplier had itself used drawback for its own inputs, but at least in the case of two major inputs for yarns (raw cotton and polyester staple fiber) this is irrelevant since the Bangladesh import duty is zero. In 2002 the subsidy rate was reduced to 15% and it was announced that it would be reduced again 2003 and 2004 and eventually phased out in 2005.

[20] These provisions are in the 2002-07 Export Import Policy (available at <dgftcom.nic.in/2000/policy/>). See sections 3.7.2.1 (duty free import entitlements for export houses), 3.4.iv (duty free entitlement for handicrafts), 5.1 and 5.3 (resale or use for domestic production of capital goods subject to reduced import duties linked to incremental exports); reduced import duties on domestic sales by SEZ firms.

bidding against duty free imports), and in India and Sri Lanka, special schemes for the export activities of trading firms.

VAT-style indirect taxes are sometimes refunded or exempted by these schemes, or handled separately by the domestic indirect tax administration rather than by the Customs administration. In order to implement these various schemes, India, Pakistan, Bangladesh and Nepal have set up organizations which systematically estimate and periodically update input-output coefficients which are used to calculate the drawback amounts and the quantities and values of duty-free imported inputs corresponding to the exported products. India has many more and also far more complex duty neutralization schemes than the other countries: e.g. three different types of drawback and two prior exemption schemes. The proliferation of duty neutralization schemes in India, and also frequent changes to which they are subject, reflects on one side dissatisfaction and pressures from exporters concerned about such things as inadequate coverage and delays, efforts by the DGFT[21] in the Ministry of Commerce which is constantly devising and revising means to streamline the systems in the interests of export expansion, and on the other hand efforts by Customs to plug loopholes based on well founded concerns about excessive revenue losses and the misuse of the mechanisms for bribery and fraud.

Because of the complex structure of tariffs and other protective taxes on many intermediate inputs in Bangladesh, the duty neutralization process can also be opaque and transaction-intensive, although for the major ready made garment sector, a good deal of these difficulties are by-passed by the use of bonded warehouse facilities. However, for machinery in Bangladesh and generally in Pakistan, Nepal and Sri Lanka, as already pointed out, the duty neutralization schemes are fewer and less complex, reflecting much less diverse export structures than India's and considerably lower and more uniform import duties.

- As well as duty neutralization schemes, most of which are separately available to exporters regardless of their location or the extent or nature of their export business, the South Asian countries are also providing *export facilities and incentives in a package to manufacturing firms which operate their own bonded warehouses, and (except in Nepal) also to firms which locate in export processing zones (EPZs),* also known as free trade zones (FTZs). Most Sri Lankan exports come from EPZ garment firms, but EPZs have always accounted for a quite minor share of exports from India, Pakistan, and Bangladesh. Since 2001, there have been efforts to increase their export role in India by renaming them and changing them to become "Special Economic Zones" offering broader and more comprehensive advantages and facilities modeled on the export zones in China. In the meantime, firms operating as bonded warehouses i.e. as EOUs, are a bigger source of exports (about 7.8% of total exports in 2000/01) than EPZ firms (about 4.2% of total exports in 2000/01), but the bulk of exports come from normal domestic firms using the various duty neutralization schemes and export incentives and facilities, especially Advance licenses, i.e. duty free import of inputs prior to exporting, and the DEPB scheme, which is a simplified form of drawback in which exporters receive salable credits against future import duties. This reflects many long- continuing inadequacies in the FTZ arrangements, especially as regards infrastructure services and regulatory controls, restrictions on the relations EPZ and EOU firms can have with the domestic market, and on the other hand improvements in the general environment for exporters operating independently of these arrangements. Some indication of the relative importance of the various export schemes in India is shown in Table 4.3.

Hard data on the relative importance of the various schemes for exports has not been found for Pakistan, Bangladesh, Sri Lanka and Nepal, but discussions and reviews of relevant literature and websites suggests the following:

[21] Directorate General of Foreign Trade

Pakistan: relies principally on drawback (Duty and Tax Remission for Exports (DTRE) scheme). There is only a small volume of exports from three functioning EPZs or based on bonded warehouse arrangements. Despite this there are official announcements that 19 new EPZs are planned.

Bangladesh: manufacturer bonded warehouses are a major source for ready made garment (RMG) exports.

Sri Lanka: most exports (principally garments) are from firms in EPZs

Nepal: most exporters use traditional drawback.

- In addition to the general export policies described above, there are a number of *policies which focus on the needs and problems of export development faced by particular industries*. Most of these schemes are in India (Table 4.1), but Bangladesh also focuses attention and assistance on at least ten export industries viz, frozen shrimp and fish, leather products, ready made garments, poultry, vegetables, fruits, bicycles, handicrafts, jute products, and bone dust. Pakistan, Sri Lanka and Nepal also pay special attention to the export potential of some of these and also of other industries, but as part of the implementation of other domestic or general export policies and not as part of a concerted separate effort mainly related to a particular industry's exports.
- Finally, all the South Asian governments operate *official export promotion organizations* which provide general and market intelligence, organize or assist exporters with trade fairs, maintain connections with relevant domestic and international organizations etc. Each country also has its own export quality inspection and control policy which is managed either by government officials or by a separate organization, such as the Export Inspection Council in India. These are just noted here and in Table 4.1 for completeness: to describe and evaluate these activities in the five countries would be a very large topic on its own, and no attempt to do so is made in this study.

Some conclusions and suggestions

During the past 20 years, and in particular during the 1990s, the general trade policies and the export policies of the South Asian countries have become much more conducive to 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 in all five countries. The following sections comment briefly on the current general situation in each country, starting with Sri Lanka where anti-export bias is certainly the lowest in South Asia, and finishing with India, where it is probably highest.

Sri Lanka. Although there are no recent empirical estimates which would enable systematic comparisons of levels and trends, the generally low tariffs and protection regime for manufacturing in Sri Lanka suggests that its trade policy environment for exports is considerably more favorable than in the other four countries. Even so, Sri Lanka's overall policies are still not neutral owing to high protection of large import substitution crops in the agricultural sector (especially rice, but also potatoes, onions and chilies) and still positive protection of the import substitution manufacturing sector, involving quite marked tariff escalation giving high effective protection rates in some cases.

Nepal. Anti-export bias in Nepal is probably also positive but overall not very marked, as apparently high effective protection for some import substitution industries available from escalated tariff

structure is reported to be undermined by Nepal's large smuggled informal trade. On the other hand, the smuggled goods mainly come from India, where high tariffs and other forms of protection cause domestic prices for many manufactured goods and some agricultural commodities to exceed world prices.

Pakistan. Pakistan's quite sweeping trade liberalization reforms after 1997 have probably cut anti-export bias there substantially, although the post reform level and structure of tariffs suggests that it still remains quite high. In addition, the extent of the probable improvement may not be well indicated by changes in tariffs and other official instruments, in view of considerable tariff redundancy at the beginning of the process, associated in part with reportedly high levels of informal imports. Nevertheless, the considerable compression and simplification of tariffs and the deregulation of agricultural policies that has occurred should in principle have simplified and reduced the administrative costs of the various export mechanisms such as drawback.

Bangladesh. Similar reductions in anti-export bias to Pakistan's occurred in Bangladesh with the trade policy reforms of the late 1980s and early 1990s. However, as noted in the previous two chapters, trade policy reform stalled for a number of years from about 1997, and only seems to have resumed, albeit in a hesitant way, after 2002. Corresponding to this slowdown, an empirical firm-level study of manufacturing indicated continuing high levels of anti-export bias during 1999/2000, 2000/01 and 2001/02, with effective protection in the domestic market available from tariffs generally two to three times greater than effective protection for manufactured exports[22]. The effective protection indicators used in the study measure protection made available by tariffs, and do not allow for the possibility of tariff redundancy which is likely to be quite marked in Bangladesh's import competing sectors, especially in view of the reportedly large volume of unrecorded imports from India. But even though actual price differences may mean that anti-export bias in practice could be lower than suggested by these estimates, this does not change the implications of the results for policy; namely, that, to the extent that they are binding, the current structure of tariffs in Bangladesh creates a marked bias in the incentive system which pulls resources into heavily protected import substitution activities with relatively low economic rates of return, and away from export activities with higher economic rates of return. The probability that high output tariffs and other protective import taxes (especially supplementary duties on top of Customs duties and the IDSC tax) are helping create large volumes of informal and "official" smuggling and the associated black economy activities, is another reason for reducing them, in addition to the desirability of shifting resources out of high cost activities into lower cost and economically more efficient activities, especially exporting.

India. As pointed out in previous chapters, as in Bangladesh, India's trade policy reforms stalled in some respects in about 1997 and churned for about the following five years, with one major new liberalizing development (the final phase-out of the general import licensing system), but with increases in the general level of tariffs, the revival of protection for the agricultural sector, and widespread use of anti-dumping, SPS and TBT rules to make life difficult for importers. There are no recent systematic empirical studies of the resulting structure of effective incentives across industries, but, if done, these

[22] Maxwell Stamp (2002), pp 53-61. The study used a standard measure of anti-export bias which divides the effective protection coefficient for exports by the effective protection coefficient for domestic sales. For exports, it used alternative assumptions that 100% of the legally refundable or exempt import duties on imported inputs used by exporters was refunded, or that only 80% was refunded or exempted. The latter assumption was made to roughly allow for inadequate refund rates, delays, and transaction costs including bribes, in getting imported input tariffs refunded or exempted. Other indicators of anti-export bias in Bangladesh are consistent with these results, in particular estimates for the 1990s which compare aggregate effective exchange rates for imports with aggregate effective exchange rates for exports (World Bank, November 1999). The comparisons of effective protection coefficients are a more accurate indication of relative incentives, however, as they take into account the typical escalated structure of tariffs, in which processing margins in production for the domestic market are widened by lower tariffs on tradeable inputs than tariffs protecting the products being produced. Effective exchange rate measures just allow for the aggregate protective effect of average tariffs and export subsidies or taxes on output prices, not for the effects on processing margins (value added).

would undoubtedly reveal the continuing existence of substantial anti-export bias, although at lower levels than during the early import substitution years, and probably declining somewhat for the manufacturing sector following tariff reductions in the 2003/04 budget.

The principal message that emerges from this brief survey of the situation in the South Asian countries, is that import liberalization remains very much at the center of the policy reforms that are needed to accelerate their export growth. This is especially true in India and Bangladesh, and should be a key consideration in Pakistan and Nepal, and even in Sri Lanka, where protection levels for manufacturing in the aggregate are much lower than in the rest of South Asia. Import policy reforms that would help accelerate exports go beyond the removal of protective non-tariff barriers and the reduction of tariffs, and should also increase the transparency of the tariff system by abjuring the use of other protective taxes on top of Customs duties. Apart from the resulting reductions in nominal protection rates, simple tariff structures using as few rates as possible (ideally only one) greatly simplify the administration and the transaction costs involved in essential export mechanisms such as drawback.

In this regard it is important to recognize that 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, inevitably become 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. To get a flavor of the kind of activity and the reactions to it, it is worth quoting from an article of a retired high level official of India's import licensing office (which was replaced by DGFT in the Ministry of Commerce in 1991). His comments concern a new rule announced in April 1995 that dispensed with the requirement that exporters should surrender foreign currency earned by their exports for Rupees, before being eligible to use duty exemption import licenses:

"This is a liberalisation only on the surface. In substance it is veritable dynamite...We can now go back to the glorious days when broken bricks and empty tin containers were invoiced and shipped as art silk fabrics, in order to obtain license for import of art silk yarn. The ingenuity of our law breakers is quite amazing, and they can come up with a number of methods by which they can obtain benefits of duty exemption license without exporting anything. All that is required is an address abroad. A relative or friend can receive the "goods " at their destination and dump them in the sea or a garbage hill. It has been stated that presently 30% of exports against duty exemption license is under hawala i.e. bogus exports. Under the revised procedure a fly by night operator does not have to pay the hawala premium[i.e. the black market premium to buy the foreign exchange which previously had to be surrendered to the Reserve Bank]. Liberalisation is a must, but it must not be custom built for the dishonest.

The Ministry of Commerce is banking on the Reserve Bank's power for taking action against exporters who do not realise the foreign exchange. It will take a minimum of six months for the Reserve Bank to know whether the foreign exchange has been realised or not. If swift action is initiated, it will take another 3 months for it to culminate in any punitive order. In the meanwhile, the offender and his ill-gotten gains will vaporize.

It is not difficult to envisage the ensuing scenario. There will be two DRI Inspectors supervising every customs appraiser. The Ministry of Commerce will blame the Reserve Bank. The Reserve Bank of India will blame the customs, who, in turn, will blame the DGFT [the Director General of Foreign Trade - responsible for import licensing in the Ministry of Commerce]. As for the political executive, it has

readymade excuses in "Bureaucratic Bungling " and of course "System Failure". The chapter will be closed after suspending a couple of clerks".[23]

The continuing need for bureaucratic checks and controls and the provision of severe penalties for not fulfilling various conditions of the export incentive schemes, have a number of consequences.[24] First, access to the schemes is limited, especially of small exporters, potential new exporters, and indirect exporters, who find the requirements for using the schemes -especially the duty exemption schemes - too onerous. Secondly, there are long delays in all aspects of the system, even though speed and agility are so important for successful exporting. For example, a survey of Indian exporters in 1994 found that it took from two to eleven months to fix input - output norms they had requested as against an official target of 45 days.[25] In order to speed up the system, for a number of years official time limits have been set for dealing with import license applications and a variety of other functions, but delays far beyond these limits are reported to be normal, usually justified by incomplete or defective applications.[26] Finally, the complexity of the system and the potential delays open the way to harassment of exporters and allegedly widespread corruption, which, according to one study, by 1995 had become institutionalised to the extent that " there is a smooth illegal market through which an exporter can get the necessary certificates and import licenses by paying bribe[s]." [27].

The problems of the Indian export incentive system described above refer to the situation in the mid-1990s with references back to the 1980s and earlier. There appear to have been substantial improvements in various aspects of the administration of these schemes since then, aided most recently by the introduction of computer technology and internet links between exporters and their agents, Customs and the DGFT. Nevertheless, continuing coverage of the system by informed outsiders[28] and a 2002 Ministry of Commerce Committee report[29] make it clear that major 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 DGFT and Customs officials. In 2002, a major corruption scandal involving falsely documented export containers shipped with the purpose of obtaining export incentive payments was reported to have involved the highest official in India's Customs and Indirect Tax administration. 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[30]. No matter what improvements are made, these episodes

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[23] Quoted from an article by I.A. Rashid,(former Joint Controller of Imports and Exports) ."Exim Policy on Balance", Impex Times, June 25, 1995,p.43.

[24] Aspects of the points made in this paragraph are emphasised and discussed in detail in World Bank (August 2, 1994).

[25] Ibid pp.10-11.

[26] The Impex Times is replete with complaints about delays justified by allegedly incomplete or inaccurate paperwork e.g. see the May 25, 1995 issue (pp41-42) and the editorial article in the September 25, 1995 issue.

[27] Article in the Economic Times, New Delhi issue, May 1, 1995, as reported in the Impex Times, May 10 1995 issue, p.7. Insofar as this report is accurate, it suggests that at least those exporters who can afford to pay the bribes are able to avoid or reduce the delays . It also should be mentioned here that there is an extensive network of consultants (many of whom are ex-officials of the import licencing authority) which specialise in obtaining import licenses on behalf of exporters and others, and also firms which buy and sell transferable import licenses. Before 1992, this network of intermediaries used to trade in particular in the transferable REP (replenishment) licenses which were abolished in the initial reforms. The REP license system and the intermediaries' role in it was a useful function which considerably reduced the economic costs of the old import licensing system, by making intermediate materials which otherwise could not be imported, available to manufacturing firms. The study to which the newspaper article refers is by Rajeesh M. Nair and Pradeep Kaul , Exporting Garments from India-Procedures, Bottlenecks and Transaction Costs. Project LARGE, National Law School of India University.

[28] Detailed week by week coverage of developments in India's export incentive policy and administration apparatus are provided in *Bigs Weekly Index of Changes* (fortnightly) and the *Impex Times* (fortnightly). The

[29] Government of India, Department of Commerce, Directorate General of Foreign Trade. January 2002. *Report on the High Level Committee for the Exim Policy 2002-07*

[30] Article by Rafiq Hasan: "Textile perks go to the wrong pockets". *Daily Star*, August 02, 2002. Available at <www.dailystarnews.com>

indicate that as long as there are economic rents inherent in the export incentive system, 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.*

Table 4.1
Export Policies in South Asia, April 2003

		India	Pakistan	Bangladesh	Sri Lanka	Nepal
Export restrictions	Export NTBs incl minimum export prices (other than controls for quality, SPS & religious/social reasons)	Yes. Fertilizers, some specialty chemicals & some agricultural commodities	Yes. A few only	Yes. Petroleum products, and agricultural, livestock and fisheries products, and wet blue leather	No	Yes. Wool carpets only
	Exports controlled by State Trading Enterprises	Yes. Petroleum products, iron ore, manganese ore, maize, niger seeds, onions	Yes. Diesel & furnace oil only	No	Yes. A few	Yes. Nepal Oil Corp.
	Restrictions on imports for packaging or blending and re-export	No	No	No . Re-export requires value addition of 10%.	Yes. Tea, spices	No
	Export taxes	Yes. Leather products only.	Yes. Bones, hides & skins only	No	Yes. Only a few low taxes	Yes General rate 2.75%
Export subsidies	Direct export subsidies, industrial products	No	No	Yes	No	No
	Indirect export subsidies	Yes (see text)	Yes. 25% freight subsidy	Yes. By low-interest loan from Export Development Fund	No	No
	Direct export subsidies, agricultural products	Yes: wheat and rice exports	No	Yes, 15% cash subsidy on Agri products (vegetables, dairy, poultry, livestock & fisheries)	No	No
	Transport and/or marketing subsidies, agricultural products	Yes	Yes	Yes, low air freight on national carrier	No	No
	Indirect export subsidies through policies affecting input prices	Yes. Leather products	Yes. Leather products	Yes, by ban on export of wet blue leather	No	Yes. Some products

	Government subsidized export financing at preferential interest rates	Yes.	Yes	Yes, export credit offered at lower than market interest rate	n.a.	No
	Government subsidized export credit guarantee schemes	Yes. Export Credit Guarantee Corp (ECGC)	Yes. Pakistan Export Guarantee Agency	Yes	n.a.	No
	Income & corporate tax exemptions or reductions for exporters	Yes. Being phased out except for EPZs and SEZs	Yes	Yes	Yes. Mainly BOI for FDI	Yes
	Grants or subsidies for new small and medium exporters	Yes	Yes	No	n.a.	No
	Duty drawback: standardized rates for products and industries	Yes. "All industry rates"	Yes	Yes	Yes	Yes
	Duty drawback: rates for specific products and exporters	Yes. "Brand rates"	Yes	Yes	Yes	Yes
	Transferable standardized drawback	Yes. Duty Exemption Passbook scheme (DEPB)	No	No	No	No
	General scheme for duty exemption on inputs imported before exporting	Yes: Advance License	No	No	No	No
	General scheme for duty exemption on inputs imported after exporting	Yes: Duty Free Replenishment Certificate (DFRC)	No	No	No	No
	Input and/or equipment import duty concessions for specific exports or exporters	Yes. Exemptions for specified end-users	Yes	Yes	No	No
	General policy for duty concessions for machinery and equipment used by exporters	Yes. Export Promotion Capital Goods Scheme (EPCG) and special schemes for garment and textile industries	No	Yes	No	No
	Use of standard input-output coefficients for export schemes	Yes. Standard Input-Output Norms (SIONs)	Yes. Input Output Coefficient Organisation	Yes	No	Yes. Under drawback committee
	Special schemes for domestically produced inputs supplied to exporters	Yes. Eligible for advance licenses, duty drawback etc	No	Yes	No	No

	Special provisions for "deemed exports"	Yes.	Yes	Yes	No	No
	Special export incentives for trading houses	Yes. Export Houses, Trading Houses, Star Trading Houses, Super Star Trading Houses	No	No	No	No
Export zones and bonded warehouses	Bonded warehouses	Yes. Export Oriented Unit (EOU) scheme	No	Yes	Yes	Yes
	Export Processing Zones	Yes. 8 zones. Becoming Special Economic Zones (SEZs)	Yes. 3 EPZs. 19 others planned	Yes. 2 EPZs. 5 more planned.	Yes. FTZs and EPZs	No. Plans only.
Export promotion and quality control organizations	Government export promotion organizations	Yes. Many.	Yes	Yes	Yes	Yes
	Government export quality control policies or organizations	Yes. Export Inspection Council (EIC)	Yes	Yes	Yes	Yes
Product and/or industry -specific schemes	Gems and jewellery	Yes.	Yes	No. Being planned	No	No
	Electronics hardware	Yes. Electronics Hardware Technology Parks (EHTPs)	No	No	No	No
	Software	Yes. Software Technology Parks (STPs)	Yes. Input and profit tax exemptions	No. Being planned	No	No
	Services exports	Yes. Duty free import entitlements	No	Yes. Contract services	No	No
	Cottage and handicraft producers	Yes. Greater general export benefits	No	Yes	No	No
	Agricultural products	Yes. Agri Export Zones (AEZs)	No	Yes. Vegetables	No	No
	Jute products	External Market Assistance Scheme	No	Yes	No	No
	Textile fabrics	Technology Upgradation Finance Scheme (TUFS)	No	No	No	No
	Frozen shrimp and fish	No	No	Yes	No	No
	Leather products	No	No	Yes	No	No
	Ready made garments	No	No	Yes	No	No
	Tea	No	No	Yes	No	Yes
Sources:						

TABLE 4.2
SOME REPRESENTATIVE TARIFFS ON INTERMEDIATE GOODS AND MACHINERY IN SOUTH ASIA

	HSC code	India March 03	Pakistan March 03	B'desh	Sri Lanka Nov 02	Nepal March 03
Inorganic chemicals	28	9.9/20.3/30.8*+AD	10	3.5/11/18.5/ 26/36	2.4	6/13/18/43
Organic chemicals	29	20.3/30.8+AD	10	3.5/6/11/18.5/ 26/36	0/2.4/ 4.8	6/13
Tanning & dyeing extracts, pigments etc	32	30.8	20/25	11/18.5	2.4	6/13/18
Plastic intermediates						
Primary form	3901-3914	30.8+AD	10/20/25	3.5/11/18.5 26/36	2.4	18
Waste, parings, scrap	3915	30.8	25	18.5	2.4	43
Natural rubber, primary forms	4001	30.8/70	15	11/18.5	12	6
Synthetic rubber, primary forms	4002	30.8+AD	5	11	2.4	6
Raw hides & skins	4101-4105	0*/25	5	0	12	6/13
Wood in the rough	4403	9.9	10	3.5	2.4	0
Wood pulp and waste paper	47	0/9.9/20.3	5/10	3.5	2.4	6/13
Wool textiles	51	9.9/20.3/25.6/30.8+S	5/10/20/25	3.5/11/18.5 26/36	0	0/6/18
Cotton textiles	52	15.1/20.3/25.6/30.8+ S	5/10/20/25	3.5/11/18.5/3 6	0	0/6/18
Man made filament textiles	54	25.6/30.8+S+AD	10/20/25	11/18.5/26/36	0	6/13/18
Staple fibre textiles	55	25.6/30.8+S+AD	10/20/25	3.5/11/18.5/ 26/36	0	6/13/18
Knitted & crocheted fabrics	60	20.3/30.8+S	15	18.5	0	13/18
Iron & steel	72	9.9/30.8*+TV+AD	5/10/25	3.5/11/18.5/ 26/36	2.4*/6/12	6/13/43
Copper	74	30.8	5/10/20/25	3.5/11/18.5/ 26/36/75.8	2.4	6/13/18/28
Nickel	75	15.1	15/20	3.5/11/26/36	2.4*/6	13/18
Aluminium	7601-7603	20.3	15	11	2.4	6/13/18/28
Lead	78	25.6	5/15	3.5/11/18.5/ 26/36	2.4	6/18
Tin	79	20.3	5/10/20	3.5/11/18.5/2 6	2.4	6/13/18
Non-electrical machinery:	84					
Calendering or rolling machines	842010	30.8	10	7.5	6	6
Cream separators	842111	30.8	10	7.5	2.4	6
Canning machinery (fruit & vegetables)	842230	30.8	10	7.5	2.4	6
Tea packaging machines	84223022	30.8	10	7.5	2.4	6
Electric pulleys & hoists	842511	30.8	20	7.5	6	6
Overhead traveling cranes	842611	30.8	10/20	7.5	6	6
Combine harvester threshers	843351	30.8	10	7.5	6	6
Paper making machinery	843920	30.8	10	7.5	6	6
Textile spinning	844520	30.8	10	7.5	2.4	6

machines						
Shuttleless looms	844630	30.8	10	7.5	2.4	6
Flat knitting machines	844720	30.8	10	7.5	2.4	6
Automatic sewing machines	845221	30.8	10	7.5	2.4	6
Shoe making machines	845320	30.8	10	7.5	6	6
Casting machines	845430	30.8	10	7.5	6	6
Metal cold rolling mills	845522	30.8	10	7.5	6	6
Machining centres	845710	30.8	5	7.5	6	6
Numerically controlled lathes	845811	30.8	5	7.5	6	6
Computers	8471	20.3	5	0	2.4	13
Ball bearings	848210	30.8	10	18.5/26/36	6	13
Electrical machinery						
Generating sets>375 KVA	850134	30.8	20	7.5	6	18
Industrial electric furnaces	851410	30.8	5	7.5	6	18
Automatic welding machines	851521	30.8	10	7.5	6	6
Agricultural tractors (new & used)	870190	30.8	25	3.5	2.4	13
Trucks of gvw 5-20 MT	87042201	30.8	60	18.5/26/36	2.4	28/83

Notes: MFN tariff rates from national tariff schedules, as percentages of assessable values. The Indian tariffs include the SAD. The Bangladesh tariffs include IDSC and supplementary duties if any, but do not allow for VAT exemptions on domestic sales (see discussion in Chapter 3). The Sri Lankan tariffs include the 20% national security surcharge. The Nepal tariffs include the national security tax in force since 2001 i.e. +1% of CIF for customs duties of 5% and below, +3% of CIF for Customs duties above 5%. Different rates for finer subdivisions of the indicated HSC code are separated by a forward slash. A tariff rate followed by an asterisk means that 95% or more of the finer subdivisions not shown in this table are at that rate e.g. 2.4*/6/12 for steel in Sri Lanka (HSC code 72) means that more than 95% of the disaggregated HSC positions in Chapter 72 are at 2.4%, so that tariffs of 6% and 12% would account for less than 5% of the total. +S means that some tariff lines are subject to specific duties, usually compound duties where the applicable duty is the higher of the maximum ad valorem rate and the specific duty. +AD means that some tariff lines are subject to anti-dumping duties applied to exports from specified firms and countries, in addition to the normal MFN duties. +TV means that some tariff lines are subject to minimum assessable values on which tariffs must be based if declared CIF values are lower. The products and HSC tariff lines were chosen more or less at random to illustrate some general aspects of the intermediate input and machinery tariff structures in these countries. The table is not intended to be comprehensive.

TABLE 4.3
INDIA 2000/01: APPROXIMATE VALUES OF IMPORTS AND EXPORTS ASSOCIATED WITH VARIOUS EXPORT INCENTIVE SCHEMES

	Imports of inputs cif $US billion	Exports fob $US billion	Share of total exports %
Drawback schemes	n.a.	n.a.	n.a.
Duty Exemption Passbook (DEPB)	n.a.	12.77	28.7
Advance (duty free) license	5.21	8.60	19.3
Duty Free Replenishment Certificate	0.34	0.51	1.1
Gems & jewellery scheme	2.42	3.39	7.6
Export Only Units (EOUs)	n.a.	3.48	7.8
Export Processing Zones (EPZs)	n.a.	1.88	4.2
Electronic hardware/software schemes	n.a.	4.67	10.5
All other	n.a.	n.a.	n.a
Total	n.a.	44.56	100.0

Source: Estimated from data in Government of India, Department of Commerce, Directorate General of Foreign Trade (January 2002). Report of the High Level Committee for the Exim Policy 2002-07.

Chapter 5: Regional Trade and Regional Trading Agreements[1]

Introduction

As discussed in the previous chapters, following independence from British rule, India, Pakistan and Sri Lanka adopted policies which made them amongst the least open economies of the world. They pursued inward-oriented, import-substituting industrialization with public sector planning and regulation of their private sectors, and their policies included stringent barriers to international trade, with many QRs, high tariffs, export controls and taxes, and regulated foreign exchange regimes. Emerging in 1971 as an independent country, Bangladesh adopted the same policies. The land-locked South Asian countries, Nepal and Bhutan, had open trade relations with their dominant neighbour, India, but followed similarly restrictive trade policies with respect to the rest of the world. Starting with Sri Lanka in 1977, these highly restrictive trade policies began to be liberalized in Pakistan, India, Bangladesh and Nepal during the late 1980s and early 1990s. But despite renewed reforms in India and Pakistan in the early 2000s, in mid-1994 South Asia remained one of the most protected regions in the global economy.

During the colonial period under British rule, the whole of British India was, in principle, and, to a large extent, in practice, a single market with well developed transport and marketing links in important regions that were subsequently divided. Customs posts and controls were erected along the new national boundaries, and, soon after, new industries were promoted and others expanded to deliberately replace imports which had previously come from overseas countries, but also from across the new borders. For example, before independence, most of Bengal's jute had been grown in what became East Pakistan, and processed in jute textile mills in Calcutta. After 1947, jute farming was promoted in India and protected by restricting the imports that had traditionally come from the east, while in East Pakistan jute textile mills were established to process jute and protected against competition from processed jute made in India. Similarly, imports of raw rubber that had previously come to India from Sri Lanka (as well as from Malaysia) were restricted in order to protect the development of a rubber industry in Kerala. Following independence, trade amongst the South Asian countries were also affected by the continuing conflict between India and Pakistan, concerns about their external and internal security, the spillover effects of ethnic and religious conflicts, a multitude of bilateral disputes (for example the "trade and transit" crisis between India and Nepal between 1989 and 1991), and a generally low level of mutual trust. India's almost autarchic policies on agriculture (dominated by parastatal import and export monopolies) and consumer goods (with a *de facto* import ban in place for almost 40 years) were especially constraining and completely blocked large volumes of Indian imports from neighbouring countries which would otherwise have taken place through legal channels.

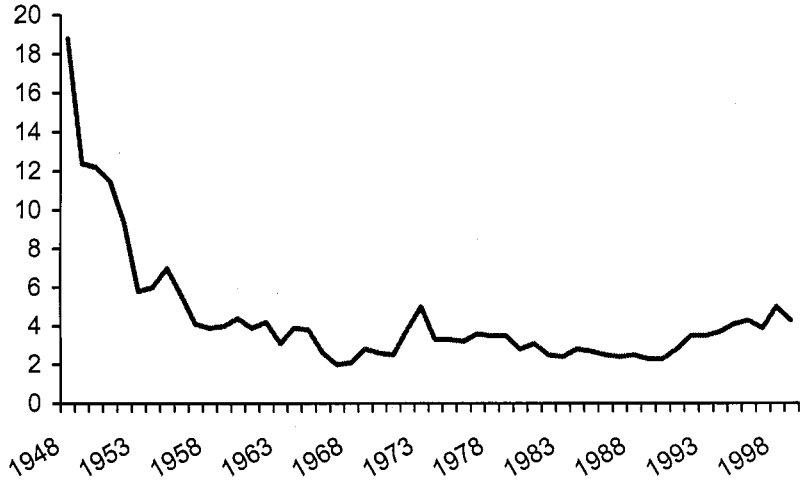
Regional trade: scale and trends

For all these reasons, with the exception of the trade of Nepal and Bhutan with India, and the trade of the Maldives with Sri Lanka, intra-regional trade in South Asia has been restricted even more than trade with the rest of the world. As shown in Fig 5.1, the trade of the newly independent countries

[1] The original version of this chapter was extracted from a paper by Garry Pursell and Nihal Pitigala (Pursell, Garry and Nihal Pitigala , 2001, August. *Trade Agreements in the South Asia Region.* World Bank, mimeo). More detail on a number of topics (especially the various bilateral trade agreements) are in this paper and in references given there. The chapter was subsequently updated and also revised to take account of new developments and also to reflect comments from discussants at workshops in South Asia. Detailed comments from I.N. Mukherji (2003, October) at the workshops in Colombo and Delhi were especially useful.

with each other fell from about 19 percent of their total trade in 1948, immediately after independence, to around 4 percent by the end of the 1950s and to only 2 percent by 1967. After recovering for a while into the early 1970s, it declined steadily again from then until 1990, when it was just over 2 percent of total trade (Table 5.1). This very low share only began to increase during the 1990s, as the general trade policy

Fig 5.1: South Asia's Intra-regional Trade as a Share of Total Trade, 1948-99



Source: Calculated from IMF Direction of Trade Statistics

Table 5.1

Officially Recorded Intra-Regional Trade As a Share of Total Trade 1981, 1990, 1995 and 1998

Country	Intra-regional Imports				Intra-regional Exports				Total Intra-regional Trade			
	1981	1990	1995	1998	1981	1990	1995	1998	1981	1990	1995	1998
India	1.3	0.4	0.6	1.1	2.9	2.7	5.1	5.6	1.8	1.4	2.7	3.2
Pakistan	1.9	1.6	1.5	2.4	5.5	4.0	3.2	4.9	3.1	2.7	2.2	3.6
Bangladesh	4.7	7.0	17.7	17.5	7.9	3.1	2.3	2.7	5.4	5.8	12.7	12.4
Sri Lanka	5.2	7.0	11.4	12.9	8.8	3.7	2.7	2.4	6.5	5.6	7.5	8.2
Nepal	-	13.4	17.5	31.7	63.8	7.7	9.2	36.2	47.4	11.9	15.0	32.8
Maldives	6.0	7.4	4.5	7.7	22.3	13.8	22.5	16.6	9.4	9.2	6.7	9.4
Bhutan	N/A	10.9	57.5	59.9	N/A	9.6	87.9	81.9	N/A	9.7	73.5	71.8
South Asia	2.4	2.0	3.8	4.3	4.8	3.1	4.3	7.5	3.2	2.4	4.1	4.9

Source: Estimated from IMF Direction of Trade Statistics.

Notes: Shares for Bhutan are based on partner data ("mirror" statistics). There are discrepancies between FOB and CIF values in mirror statistics. The large decline in Nepal's regional trade in the early 1990s was due to the "trade and transit" crisis with India, during which India closed a number of key trade and transit points with Nepal.

liberalizations in the individual countries began to take hold, and reached around 5 percent of the region's total trade in 1999. However, since then, despite some apparent progress in increasing the scope of the principal regional preferential agreement (SAPTA) and the commencement of the India Sri Lanka Free Trade Agreement (ILFTA) in March 2000 (see below) there was very little change in this still very low share of recorded regional trade in South Asia's total trade (Figs 5.2, 5.3 and 5.4). Regional trade in South Asia (over 80%) overwhelmingly consists of bilateral trade between India and the countries on its periphery, and according to India's trade statistics, the share of India's trade with its six South Asian neighbours in its total trade increased only marginally during the five years after 1997/98: in 2002/03 the share was just below 3%. The Indian data for this period also show that the basic patterns of regional trade that emerged during the 1990s have continued. In particular:

Fig 5.2
Indian trade with South Asia countries 2002/03

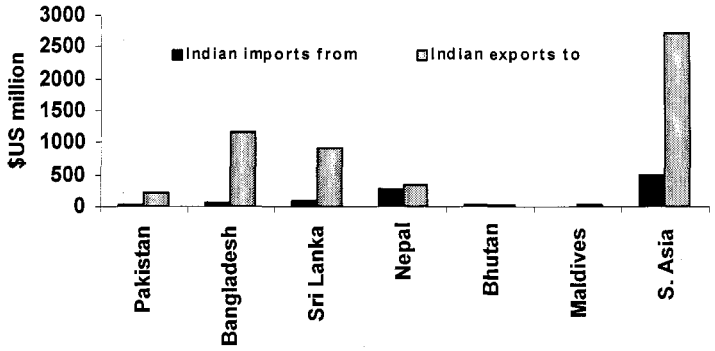


Fig 5.3.
Share of recorded South Asian trade in India's total trade, 1997/98-2002/03

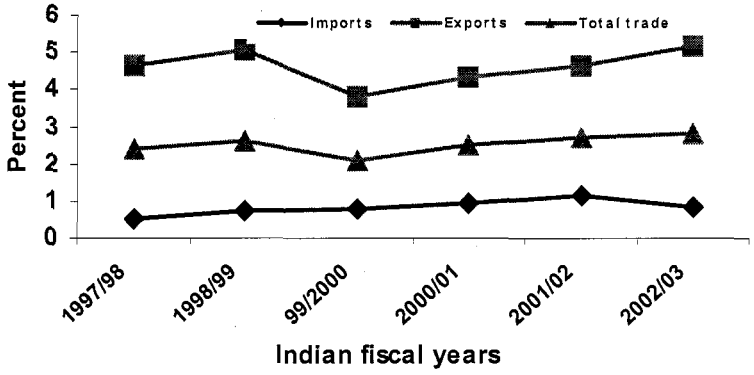
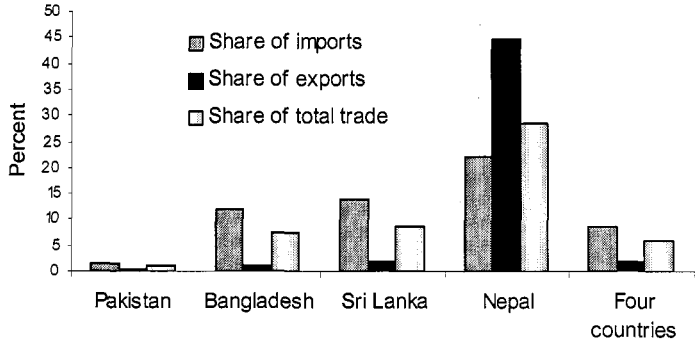


Fig 5.4
Four Asian countries 2002/03: shares of trade with India in total imports, exports and total trade



- Regional trade is dominated by exports from India, which in 2002/03 accounted for 84.4% of its total regional trade and probably about three quarters of total regional trade[2]
- Most of India's regional exports go to Bangladesh and Sri Lanka, both of which consistently run large trade deficits with India (Table 5.2). India also has regular trade surpluses with Pakistan and Maldives, although the total volumes of trade are small (especially considering the potential for trade with Pakistan).
- According to India's and their own trade statistics, Nepal and Bhutan normally run trade surpluses with India[3], but the total volumes of this trade is very small from India's perspective (about half of one percent of its total trade)
- Likewise, for India, imports from the South Asian region are tiny relative to its total trade: less than one percent. South Asia is a somewhat more important destination for India's exports, accounting for about 5% of its total exports (Fig 5.3).
- For all the countries on India's periphery except Pakistan, regional trade, nearly all of which is bilateral trade with India, is much more important than it is for India (Fig 5.4). In particular, India is a major source of imports for Bangladesh and Sri Lanka (in 2002/03 12.2% and 13.8% of their total imports respectively), but a very minor export destination (in 2002/03 0.9% and 1.8% of their total exports). But India is by far the dominant trading partner for Nepal and Bhutan, both for imports and exports.
- The almost negligible share of Pakistan in South Asian regional trade reflects the political difficulties between it and India. Without these difficulties, the trade would undoubtedly be much larger, at the very least in absolute and relative terms as large as the India-Bangladesh and India-Sri Lanka trade.

The official trade statistics just discussed omit large volumes of unrecorded trade in the region, which takes a number of forms, including traditional smuggling which physically by-passes Customs posts (especially at the land borders), "official" or "technical" smuggling which involves misclassification, under-invoicing etc at Customs, and indirect smuggling which includes, for example,

[2] This assumes that about 15% of total regional trade in 2002/03 was between the peripheral countries. Complete data on trade between the peripheral countries in 2002/03 is not yet available.

[3] India's trade statistics showing a surplus with Nepal in 2002/03 appear to be a-typical. There are major discrepancies between India's and Nepal's official trade statistics, but both normally show a trade surplus for Nepal. The apparent trade surpluses (according to Indian official statistics) of Bhutan with India probably reflect failure to record Bhutanese imports under the bilateral free trade agreement with India. Bhutan's principal export to India is electricity, which is not included in the merchandise trade statistics.

exports to Pakistan from India which are routed through Dubai or Afghanistan. Recent studies of this informal unrecorded trade suggest that it may be as large as the recorded India-Nepal trade, but that it is probably considerably less than the recorded India-Bangladesh trade and seems to be declining, and is also much less than the recorded India-Sri Lanka trade. There are no recent studies or estimates of the likely scale of the informal India-Pakistan trade, but the tightening of security along the India-Pakistan border since 1998 suggest that informal trade with India by the principal land routes is probably much less than it was generally considered to be during the early and mid-1990s. The recent studies also suggest that the direction of the informal trade is similar to the direction of recorded trade. In particular, Nepal probably normally runs a surplus with India on informal trade account, while India runs a substantial informal trade surplus with Bangladesh.

There are a number of reasons for the overwhelming predominance of Indian exports in regional trade and the failure so far of the peripheral countries to substantively penetrate the Indian market. Most fundamentally, India has a far more diversified economy than the other countries, especially in manufacturing, and many of its products-notably durable consumer goods, intermediate materials, components and certain kinds of machinery- are especially well suited to buyers in the region, in terms of price, quality and adaptation to South Asian conditions. At the same time, tariff structures in the other South Asian countries have systematically been amended to increase the processing margins of established local industries by cutting the tariffs applied to imports of many raw materials, intermediate components and machines that are not domestically produced. India is very competitive with the rest of the world in the production and export of a number of these products and has been successfully supplying them-notably to Bangladesh and Sri Lanka-in competition with exporters in the rest of the world, and in nearly all cases without any assistance–or at least any substantive assistance-from tariff preferences. Thirdly, the peripheral economies are far smaller than India's in every dimension, and their export industries are appropriately much more specialized in producing labor intensive consumer goods-e.g. textiles, garments, leather goods, seafoods, various agricultural products-which are also low cost internationally competitive industries in India. The consequent basic difficulty of exporting these labor intensive products to India on any substantial scale is made even more difficult by high "just-in-case" protection of these industries in India e.g. prohibitively high specific duties on low -value textile fabrics and garments principally aimed at keeping out imports from China and other low cost developing country suppliers, and very high tariffs over wide ranges of agricultural products (for more discussion on this see the chapter on agriculture, livestock and fisheries and the chapter on textiles and clothing in Volume II). Fourth, although under SAPTA and ILFTA (see discussion below) India has granted a large number of tariff preferences, many of these are on products which are either not produced and exported by the other South Asian countries, or which, if they are produced (e.g. garments), are subject to special high protection treatment in India. Fifth, (for many reasons including political tensions and priority to more profitable and bigger opportunities in the domestic market and in exporting to developed countries), so far there has been little or no direct investment by Indian firms in the peripheral countries as a means of more profitably sourcing supplies for the Indian market. Finally, as discussed in Chapter 1, the correction to many years of exchange rate overvaluation that resulted from the massive devaluation of the Indian Rupee between the mid-1980s and 1992, involved correspondingly large real devaluations in India's bilateral real exchange rates with Pakistan, Bangladesh and Sri Lanka. This provided an initial impetus to the expansion of Indian exports to these countries during the 1990s at the same time as their non-tariff barriers and tariffs were being reduced, while increasing the difficulty for exporters in these countries to profitably supply India.

Early regional trade agreements

The South Asian countries have always been conscious of both the economic advantages and of the political and other difficulties of less restrictive regional trade. Consequently, there have been many initiatives to free up trade. This section briefly summarizes the principal early agreements, which in modified forms, are still in force.

The India-Nepal Treaties of Trade and Transit

Trade between India and Nepal are centuries old, trade having been carried out traditionally on a barter basis. Trade relations are strongly influenced by, and have often been subordinate to political, security and military considerations, especially the Indian preoccupation with China. This led to a major breakdown in Indian-Nepalese relations between March 1989 and May 1991. During this period India closed key trade and transit points with Nepal, thereby effectively creating a partial economic blockade with respect to a number of crucial commodities, especially petroleum products. The blockade only ended in 1991 with a constitutional crisis and change of government in Nepal. Since then, this experience has been a dominant background factor in the political and economic relations between the two countries.

The Indo-Nepal Treaty of Trade, signed in 1950, was the first formal post-independence trade agreement in the South Asia region. The Treaty was renewed in 1961 and in 1971 and modified to incorporate provisions on transit facilities extended by India for Nepal's trade with third countries, and cooperation to control unauthorized trade, the principal concern of the latter being smuggling of third country goods from Nepal into India. The treaties were formally suspended during the trade and transit crisis and were renewed only in December 1991 following the change of government in Nepal. In December 1996 a new Treaty of Trade[4] was signed with the provision for automatic renewal every five years. In January 1999 a new Treaty of Transit liberalized transit arrangements in Calcutta for Nepalese imports, and the Treaty was made automatically renewable every seven years. Frequent bilateral consultations are held between the Indian and Nepalese Customs to deal with the administration of these agreements.

An early protocol to Article V of the Treaty of Trade stipulated that such goods must contain not less than 80 percent of Nepalese materials, or Nepalese and Indian materials, to be eligible for concessions. This was much too stringent for exporters in Nepal to make much impact on the Indian market. In subsequent revisions to the Treaty and the relevant Protocol the proportion of value added was first lowered to 65 percent and later to 55 percent, but these rules of origin still proved too demanding for the underdeveloped Nepalese manufacturing sector to make much progress in exporting to India, at least by legal means.

Reflecting this, these percentage rules of origin requirements were eliminated in the December 1996 Treaty. Between then and 2002, all goods manufactured in Nepal were exempt from Indian QRs and also from Customs duties provided they were accompanied by a Certificate of Origin (COO) issued by authorized agencies in Nepal. This was essentially an *ad hoc* rule of origin system, in which the admissibility of each shipment for duty-free treatment was sequentially decided by the administering Nepalese agency and then by the Indian Customs. However, after a few years the system was questioned by manufacturers in India, who complained of competition from duty free imports from Nepal, especially

[4] Details of the Treaty provisions with respect to Indian imports from Nepal are in Arun Goyal (ed) *Easy Reference Customs Tariff*, Budget Edition (2003-04). This also gives information on the January 1999 Treaty of Transit. A comprehensive account of the Agreement and Protocol to the Treaty of Trade up to 1995 is provided in V.L Rao, Srinath Baruah, R. Upendra Das (1996). .

of hydrogenated edible oils (vanaspati), acrylic yarns, copper products, and zinc oxide, all of which were heavily protected in India. In response the Indian government re-imposed origin rules, which at present set the maximum share of non-Nepalese or non-Indian materials in export prices at 70%. In addition, quotas were set for the four products mentioned above, and in one case (vanaspati) the quotas were allocated to an Indian state trading enterprise (the State Trading Corporation) as a way of appropriating the considerable resulting economic rent. Nepalese exports in excess of these amounts are subject to India's normal MFN tariffs. To further reinforce protection, Nepalese exports of one of these sensitive products (acrylic yarn) were subject to an anti-dumping action and anti-dumping duties were imposed.

Manufactured goods not accompanied by a satisfactory COO would fall into three categories, none of which can be exported to India, at least legally. The first and most important are imports into Nepal from third countries: the import of these into India was always prohibited if the Nepalese import duty had been rebated, but in January 1996 the Indian Customs made this prohibition quite general, so that it applies to any third-country goods, even if Nepalese Customs duties have not been rebated. The second category is Indian goods which have been exported to Nepal and which have received a Nepalese Customs credit for Indian excise duties (see below). The re-import of these goods into India is banned, as a way of discouraging this potential method of evading Indian excise duties. The third category is Nepalese goods first sold domestically and then exported over the border to India. In that case they would be subject to both Indian import duties and Indian excise taxes, and in most cases, coming on top of Nepalese indirect taxes, the total taxes involved would be prohibitive. The same basic principles apply to agricultural products exported to India: to qualify for QR and duty exemption, they must be "wholly produced" in Nepal.

On the Nepalese side, under the Treaty of Trade, Nepal extends a reduction of 20 percent in import duties on goods imported from India with customs tariffs up to 40 percent, and a reduction of 10 percent in import duties on goods with customs tariffs in excess of 40 percent and up to 110 percent. The Nepalese preferences are therefore mostly quite small e.g. a 12 percent tariff instead of a normal tariff of 15 percent, or an 8 percent tariff instead of a normal tariff of 10 percent.

There are separate special arrangements for dealing with Indian indirect taxes. In contrast to Indian exports to other countries, which in most cases are effectively exempted from excise and sales taxes, these taxes have in general already been imposed on Indian products sold in Nepal, and it would be impractical to refund them to the traders and others who bring them in through the border Customs posts. To deal with this, the agreement and practice for many years has been for the Nepalese Customs to deduct the amount of the Indian central excise tax "and other duties"[5] from the Nepalese import duties and other charges, so that the importer only pays the difference, if any. With an upper limit equal to the Nepalese duties and other charges, the Indian indirect taxes on the imported goods are then paid by the Indian government to the Nepalese government: in recent years these payments have amounted to about 5 percent of total Nepalese government tax revenue.

Under the Treaty of Transit, India provides port facilities at Calcutta and Haldia for Nepal's trade with third countries, including procedural and other concessions and the facility of 15 points of entry/exit on the India-Nepal border and as many transit routes to Calcutta and Haldia.[6]. Nepal can also use the facilities at the Mumbai port and the Kandla port for third country trade. In addition, India has provided 22 entry/exit points along the India-Nepal border for bilateral trade and for Nepal-Nepal transit. Nepal's

[5] Presumably central sales taxes. There do not appear to be any special provisions in the Treaty on Trade or in other laws affecting India-Nepalese trade, regarding the treatment of Indian or Nepalese state or provincial sales and other indirect taxes.

[6] International obligations oblige landlocking countries such as India to provide landlocked countries such as Nepal with at least one transit route to the sea.

traffic in transit through Indian territory is exempt from Indian customs duties, all transit duties, and other charges except for transportation. It is unclear however, whether octroi (municipal levies charged for goods transported across municipal borders in India) applies to transit goods.

To be effective, the Customs procedures described above would require efficient administration and reasonably accurate and complete record keeping at the border Customs posts, since there are substantial incentives to falsify records, and even more to avoid both Indian and Nepalese excise and sales taxes by bypassing Customs inspections altogether. The transaction costs of preparing and negotiating the certificates of origin required for each Nepalese shipment to India could also be considerable, especially in relation to small shipments. The information and documentation requirements for both Customs officials and traders are also high e.g. as regards previously paid Indian excise taxes included in the prices of goods exported from India to Nepal. For these reasons, it is not surprising that the volume of informal, unrecorded trade is reported to be very high, even for products which are exempt from import duties under the Treaty of Trade.[7] Over many years substantial leakages into India have also been reported from duty free bonded shipments passing through India to the Nepalese border. All of this leads to complaints and pressures from Indian firms to plug the leakages, but while Indian protection remains much higher than protection in Nepal, it is difficult to envisage viable administrative solutions[8]. For these reasons trade relations have been a constant source of friction between India and Nepal, as is apparent from the following Indian assessment of the situation in October 2000:

"Apart from the informal movement of third- country origin goods through the unmanned borders with Nepal, the official imports through the customs points are third country goods in the disguise of Nepal-origin goods....Nepal trade is legalized smuggling with a wide network covering politicians, police, officials and businessmen on both sides of the border"[9].

Large tariff reductions in India since 2002 and some tariff increases in Nepal (see Chapter 3) will have reduced the incentives for "trade deflection" through Nepal as a means for exporters from other countries to access the Indian market. However, applied research on the transaction costs of the border trade[10] suggests that substantial simplifications of import and export procedures and improvements in Customs administration would also be needed for there to be a really substantial redirection of trade to formal channels.

Agreement on Trade and Commerce Between India and Bhutan

Being land-locked, Bhutan traditionally traded only with India, and their trade was conducted freely without a formal accord. Article V of the Treaty of Perpetual Peace and Friendship signed between India and Bhutan in 1949 implicitly recognized the existence of free trade between the two countries, but it was not until 1972 that this was made explicit and formalized in the Agreement on Trade and Commerce. [11] This agreement was prompted by the gradual development of the Bhutanese economy and

[7] Pohit and Taneja, (2000)

[8] The effects of high tariffs in India were apparent from a complaint by Indian copper wire producers who asserted that copper rods were being imported into Nepal with a 5 percent duty and after a simple drawing operation in Nepal were being imported duty free into India as finished copper wire. By contrast, in 2000 Indian copper wire producers were importing copper rods over a tariff of approximately 45 percent. Arun Goyal, "Export Import Notes", *Economic Times,* October 9, 2000. Since then, copper and copper wire tariffs in India have been reduced to 20%, substantially reducing the incentive for "trade deflection" to India through Nepal.

[9] Ibid

[10] Pohit, Sanjib and Nisha Taneja (2000) and Karmacharya, B.K. (2002).

[11] As well as facilitating trade and payments, this agreement included broader objectives under which India would help further the economic development of Bhutan by providing technical and financial assistance for economic development and diversification.

the need to distinguish Bhutan's border trade from its growing trade with other countries. The agreement has been periodically renewed and will be in force until 2005.

Among the major provisions, Article II of the Agreement gives Bhutan the right to impose non-tariff barriers on goods of Indian origin "as they may be necessary for the protection of industries in Bhutan", with the provision that these NTBs would not be stricter than those applied to goods imported from third countries. However so far no NTBs have been imposed. Article III allows both countries to impose non-tariff barriers to goods originating from third countries. A protocol to the agreement outlines the procedures for all imports and exports of Bhutan to and from countries other than India and specifies 12 road depots, seaports and airports in India through which this trade may take place. A comprehensive import procedure has been annexed to the protocol to avoid goods destined to Bhutan from leaking into India. A notable absence from the agreement are rules of origin stipulating the local content requirement of goods of goods that can be traded duty free between the two countries. There are also no Certificate of Origin requirements, as in Nepal.

Arrangements similar to those in Nepal exist for the treatment of excise and sales taxes. These taxes included in the cost of Indian goods sold in Bhutan are a major revenue source for the Bhutanese government, approximately 13 percent of the government's total tax revenue in 1998/99. But, as in Nepal, the evasion of indirect taxes is a big incentive to bypass formal trade channels and Customs procedures, and it is reported that the volumes of unrecorded trade between the two countries are large relative to Bhutan's total recorded trade.

Bhutan's trade is dominated by electricity exports to India from hydro power stations financed and constructed by Indian companies. Relative to the economy, this activity is far larger than the production and trading of agricultural and manufactured goods, and also accounts for a large share of total government revenue. As in Nepal, tourism is also an important export service industry.

Bilateral trade agreement between Bangladesh and Bhutan

After India, Bangladesh is the second largest export destination for Bhutan. The main provision of a trade agreement between the two countries are tariff preferences given by Bangladesh. The agreement was renewed for five years in May 2003. However, even with the preferences the total protection rates in Bangladesh for Bhutan's principal exports are high, and the preference margins are quite small. For example, as discussed in Chapter 3, after allowing for the preferences, in 2003/04 Bangladesh's total protective import duty rate for apples and apple juice (which are two of Bhutan's principal exports) were 65%, versus an MFN protection rate of 86%. Similar very high preferential protective rates were also applied to other exports which are important for Bhutan e.g. to mandarins and oranges. As noted in Chapter 3, these very high protection rates are the consequence of Bangladesh's para-tariffs (for these products a 40% "supplementary" duty), which are not subject to the preferences applied to Customs duties. Protection rates at these very high levels appear to be supporting high cost marginal producers in Bangladesh, and are symptomatic of the reluctance to seriously pursue preferential trading opportunities which would probably generate large trade volumes, but which would possibly hurt some domestic producers.

Trade and Transit Agreements between India and Bangladesh

India has historically been the largest single trading partner for Bangladesh, and Bangladesh has been the largest export market for India in South Asia. Previously East Pakistan, Bangladesh emerged as an independent country in 1971, following a war in which East Pakistan received crucial support from India. Immediately after, in March 1972, the two countries entered into a trade agreement the principal

provision of which was mutual MFN treatment[12]. In November 1972, a Protocol on Inland Water Transit and Trade was signed in accordance with Article V of the main trade agreement for a term of five years. This agreement provides for the use of specified waterways, railways and roadways for commerce between the two countries and for passage of goods between two places in one country, through the territory of the other. The trade agreement was renewed annually until 1977, but political differences led to its suspension for about three years between 1977 and 1980. Eventually a new trade agreement containing similar provisions to the original agreement was signed in October 1980, and the Protocol on Inland Water Transit and Trade has subsequently been periodically extended. The essence of this Protocol is 50/50 sharing of barge trade both between India and Bangladesh, and trade between different parts of India (e.g. Kolkata to Assam) which uses waterways passing through Bangladesh.

While these agreements are essential for the existing trade and transit arrangements between the two countries, their scope is quite limited and both trade and transit activities between the two countries remain highly constrained. For example, Indian trucks are not permitted to supply customers inside Bangladesh or to carry shipments in bond across Bangladesh to the Indian states on Bangladesh's eastern and north-eastern borders. Likewise, Bangladesh trucks are not permitted to operate in India. Apart from the extra costs that this imposes on inter-country trade, as a result, large volumes of intra-Indian trade between the western and eastern states are carried by circuitous and extremely long routes via the narrow "chicken's neck" region between the far north of Bangladesh and Nepal, Sikkim and Bhutan[13]. In addition, these bilateral trade and transit agreements do not cover the severe constraints on legal India-Bangladesh border trade, which result from the fact that most land Customs posts (both in India and Bangladesh) are only authorized to clear a very limited number of specified products. This creates obvious motives for smuggling, since the only legal alternative is frequently to transport the goods to a distant location where the Customs posts are authorized to clear them. The agreements also never included any preferential tariffs or other preferential trade concessions. As discussed below, trade preferences were negotiated separately, first under the Bangkok agreement, and later under SAPTA.

Bangkok Agreement

The Bangkok Agreement[14] resulted from an early initiative to liberalize trade between ESCAP[15] members. It was signed in Bangkok in 1975: the original signatories were India, Bangladesh, Sri Lanka, South Korea and Laos. In 1991 China joined, greatly increasing the potential scale and importance of the agreement. Articles 3 and 4 provide for tariff concessions and the relaxation of non-tariff barriers in favor of goods originating in the participating states. These are set out in national lists of concessions, which are compiled by each country at negotiation sessions. The participating states also agreed to accord the MFN principle to each other,[16] with the exception of concessions to a "least developed country" (LDC) member, which can be given to that country only. The LDC members are currently Bangladesh and Laos[17]. Concessions that are accorded by a "participating state" outside the Bangkok Agreement, such as tariff concessions given by India to Sri Lanka or vice versa under SAPTA, do not apply to other Bangkok Agreement participating states by virtue of their participation in the agreement. The rule of origin that has to be met for goods to qualify for concessions is that the total material and labor cost incurred in the

[12] This agreement was redundant, since both countries were in any case obliged to accord MFN treatment to each other as GATT signatories, and after 1995 as members of the WTO.

[13] Aspects of India-Bangladesh-Nepal trade logistics are described and analysed in Subramanian and Arnold (2000)

[14] The full formal title of the agreement is : First Agreement of Trade Negotiations Among Developing Member Countries of the Economic and Social Commission for Asia and the Pacific.

[15] United Nations Economic and Social Commission for Asia and the Pacific

[16] This meant that the other member countries would give each other GATT MFN treatment and hence would not discriminate against Laos even though it was not a GATT signatory.

[17] Laos dropped out in 1990 and Papua New Guinea acceded in 1993. Since then Laos has rejoined and Papua New Guinea has left.

exporting country or in other Bangkok Agreement countries should account for at least 50 percent of the ex-factory cost of the product. This is extremely demanding for the smaller countries and has been a major reason for the minimal impact of the agreement on trade so far.

A standing committee representing the participating members meets at least once a year to review the progress of trade between the member countries and to sponsor negotiations. Despite the frequency of these meetings, national lists of concessions and the extent of the concessions were not substantial enough to have a perceptible impact on trade flows. During the agreement's first 25 years, for all member countries there were tariff concessions on only about 500 six-digit HSC products, compared with approximately 5300 six-digit HS product categories, and there were practically no concessions on QRs. Moreover, particularly in the case of India, the tariff concessions that were given were often meaningless, since the same products were frequently subject to import licensing, and especially before India's trade liberalization reforms during the 1990s, the preferential tariffs it accorded were still prohibitively high[18]. Consequently, trade among the signatory countries from 1980 through the 1990s remained at only about 2.2 to 2.5 percent of their total trade[19], and nearly all the increases that occurred during the period e.g. the expansion of South Korea's exports to India and to the other member countries, had nothing to do with concessions negotiated under the Agreement. The scope and value of the Bangkok Agreement tariff preferences in South Asia increased somewhat during the 1990s-especially tariff preferences given by India to Bangladesh-but by then trade developments in South Asia were dominated by the unilateral liberalizations that had occurred or were under way, and SAPTA and other regional trade policy initiatives began to have a more important role.

China's accession to the Bangkok Agreement in 2001 seemed to have the potential to fundamentally change the impact and effects of the agreement on trade. However, at the time China's concessions were on only 902 8-digit HS product lines, plus 18 tariff lines for Bangladesh. Most of these concessions were minimal e.g. for tyres China offered a preferential tariff of 12.6% instead of its general tariff at the time of 12.9%[20]. Chinese trade with South Asia, especially with India (both exports and imports) have been expanding very rapidly since about 2001, but as is the case with South Korean trade, this has little or nothing to do with the Bangkok Agreement concessions. In fact, the principal thrust of Indian trade policies towards China has been restrictive, on the import side through anti-dumping measures which have targeted Chinese exporters, and specific tariffs on textiles and garments (see Chapter 3), but also on the export side during 2003/04, with discussion of measures to restrict booming exports of iron ore and steel to China, as a way of limiting the impact of this trade on domestic producers. Therefore, it seems that, as in the past, the Bangkok Agreement's role is mainly symbolic and political, with minimal real impact on trading relations in the South Asia region.

South Asia Preferential Trade Agreement (SAPTA)[21]

As far back as 1975, the South Asian heads of state discussed the formation of unions with political, social and economic objectives. The increasing number of regional arrangements among developing countries in other parts of the world also influenced thinking in South Asia. This was the background to the establishment of the South Asian Association for Regional Cooperation (SAARC) - comprising India, Pakistan, Bangladesh, Sri Lanka, Nepal, Bhutan, and the Maldives - in December 1985.

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[18] For a discussion of the Bangkok Agreement in relation to Indian trade policies, see Pursell (1999).
[19] Fischer (1998)

[20] The 2001 Bangkok Agreement concessions are on ESCAP's website www.unescap.org/tid/Bkkagr.asp (updated to 2004). The website does not indicate whether the concessions reported there are still current.
[21] In South Asia the agreement is also often referred to as the "SAARC Preferential Trade Agreement".

A notion that deeper trade interaction can create functional spillovers that would help build stronger general ties has long been in the minds of South Asian policy makers. Although the acceleration of economic growth through regional cooperation was incorporated as an objective in the SAARC Charter in 1985, it was not until 1987 that an explicit commitment to cooperation in the area of economic development was adopted. This eventually led to the signing of SAPTA at the seventh SAARC summit in 1993, in Dhaka. The agreement provides a framework and institutional base for trade liberalization and economic cooperation between the seven SAARC member countries.

The agreement provides for the exchange of concessions between SAPTA members on tariffs, para-tariffs[23] and non-tariff barriers. It envisages four basic approaches to the exchange of trade preferences: (1) product-by-product; (2) across- the-board; (3) sectoral ; and (4) "direct trade" measures.[24] Key aspects of the agreement are the following:

"Special and Favorable Treatment" As do the UN agencies and the WTO, SAPTA distinguishes between its members according to their level of economic development. Bangladesh, Nepal, Bhutan and the Maldives are defined as "Least Developed Countries" (LDCs) and are treated differently from the three "non-LDC" members, India, Pakistan and Sri Lanka. The agreement provides for "Special and Favourable Treatment" for the LLDCs by the non-LLDCs, including deeper and wider tariff preferences; favorable terms for technical assistance; the provision of special facilities with regard to shipping; assistance with the preparation and establishment of industrial and agriculture projects; training facilities; and support in marketing.

Regional MFN principle. A unique feature of SAPTA is the application of a regional MFN principle with regard to its members. Under this principle, tariff or other concessions accorded by a non-LLDC to another non-LLDC are extended unconditionally to all member countries. However, concessions extended by a non-LLDC to an LLDC are automatically applied only to other LLDC members. This clause was inserted in the hope that it would encourage India, Pakistan and Sri Lanka to give more generous tariff and other concessions to the LLDCs without worrying that doing so would automatically generate import competition from each other.

Rules of Origin. The SAPTA rules of origin (ROOs) distinguish between goods that are "wholly produced or obtained" and goods that are not "wholly produced or obtained" in an exporting SAPTA country. The former includes domestic raw materials, agricultural products, fish, waste and scrap, and products wholly obtained from these inputs. As regards the latter, the agreement initially provided that the total value of the materials, parts or produce originating from non-contracting states or of undetermined origin and used in the production of the exported product, should not exceed 50 percent of the f.o.b. value, *and* that the final process of manufacture was performed within the territory of the exporting member state. The non-local inputs are valued at their cif prices where obtainable, or otherwise at "the earliest ascertainable price" paid for them in the exporting country. It is apparent that this is equivalent to a "local content" requirement of 50 percent of the fob price. In order to encourage regional value addition, the agreement also includes a "cumulative" rule of origin which initially said that goods processed in more than one member country can be eligible for concessions provided that the value added in SAPTA countries was at least 60 percent of the fob value. These ROO local content provisions have

[22] Agreement of SAARC Preferential Trade Agreement, 1995, SAARC Secretariat, Kathmandu, Nepal.

[23] That is, discussed in Chapter 3, border and other taxes having the equivalent or similar protective effects as Customs duties.

[24] Product-by-product" means negotiating at HS 6-digit tariff line level. "Across the Board" means a uniform reduction applying to all products under negotiations. "Sectoral basis" means agreements on groups of products which are closely related in end use or in production. "Direct trade measures" means such things as long and medium term contracts containing import and supply commitments in respect of specific products, buyback arrangements, state trading operations, and government and public sector procurement.

been a contentious issue and were subjected to continuous scrutiny by members who realized that the effectiveness of SAPTA was quite limited, in part due to low value addition in many of their most competitive exports. After much resistance, particularly from India, at the SAARC Council of Ministers meeting held in March 1999, the local content requirement was reduced to 40 percent for non-LDCs and to 30 percent for the four LDCs, and the "cumulative" origin requirement was reduced to 50 percent[25].

The principal objective of SAFTA is expand the scope of tariff concessions and thereby promote regional trade. Following three negotiating rounds held during the 1990s, the proportions of traded and tradable commodities covered by regional tariff concessions was extremely low: for all seven countries, on average only 8.4 percent of 5300 tariff lines in the case of imports from India, Pakistan and Sri Lanka, and 6.2 percent on average in the case of imports from the four LLDCs (Bangladesh, Nepal, Maldives and Bhutan).[26] This also comes out if the concessions are evaluated in terms of import values rather than number of product lines. For example, in 1998 total imports by a SAPTA country from other SAPTA countries, of products subject to a SAPTA concession by at least one member during the three SAPTA negotiating Rounds, were about US $480 million.[27] This was equivalent to only about 15 percent of the total imports of SAPTA countries from other SAPTA countries in that year. This situation has changed very little since the late 1990s. Both these statistics make it clear that SAPTA is so far from fulfilling the requirement of Article XXIV of the GATT rules for regional integration arrangements, which requires that they cover "substantially all trade". In addition, the rules of origin, already discussed, further limit the potential of SAPTA for increasing regional trade. Overall, as concluded by Mukherji, under SAPTA "the steps advanced have been short, hesitant and in the final analysis, halting".[28]

It is generally agreed in South Asia that SAPTA has had a minimal impact on intra-regional trade. Most of the observed increases in intra-regional trade can be attributed to the unilateral liberalization efforts of the individual countries, and during the late 1980s up to about 1992, the appreciations of the currencies of the larger peripheral countries vis-à-vis the Indian rupee. Furthermore, a significant portion of the increases came from increased Indian exports to Bangladesh and Sri Lanka which had little or nothing to do with SAPTA concessions. The principal reasons for the very limited impact of SAFTA are:

- The extreme reluctance to make any meaningful concessions in the earlier years, on all sides, but especially on the part of the smaller countries in relation to India.

- Until it was lifted for the SAPTA countries in 1998, India's import licensing system which effectively banned the imports of nearly all consumer goods (including agricultural products) from all sources.

- The controls of India's parastatals over imports of major agricultural commodities

- The political problems and hostilities between India and Pakistan and the consequent reluctance of both countries to give tariff concessions to the other

- Pakistan's ban on all imports from India, except for its "positive list" (currently about 677 products and product groups). This prevents the three "non-LDC" members from negotiating concessions between each other except for products on Pakistan's list, and was one of the principal reasons Sri Lanka negotiated its free trade agreement with India (see below). This by-

[25] This issue was discussed during the third negotiating round.
[26] The estimate for LDCs is based on data in Mukherji (2000).
[27] Mukherji (2000) p.11
[28] Iibid p.25.

passed SAPTA and from a strictly trade viewpoint, has made SAPTA almost irrelevant for Sri Lanka.

The India- Sri Lanka Free Trade Agreement (ILFTA) [29]

Indian exporters to Sri Lanka were among the beneficiaries of the Sri Lankan general liberalization of its trade regime which commenced in the late 1970s and continued during the 1980s and 1990s.[30] Against this background, policy makers in Sri Lanka became increasingly concerned about the growing bilateral trade deficit with India and looked for ways of reducing it. But they realized that, because of Indian QRs and the complexities involving India-Pakistan relations, it would be futile to seek preferential reductions in Indian tariffs across a broad range of commodities of interest to Sri Lankan exporters, through SAPTA. They therefore pressed India for a separate trade agreement outside the SAPTA framework. This agreement finally became effective on March 1st 2000. The general objective of the agreement is the elimination of tariffs on all goods except goods included in specified negative lists according to agreed timetables. The agreement does not explicitly refer to QRs , presumably because, by the time it was signed, India had already removed its balance-of-payments-justified QRs for the SAPTA countries, and nearly all QRs had been eliminated in Sri Lanka long before. The agreement is administered by a joint ministerial level committee. A working group on customs issues, including the harmonization of tariff categories had also been established, which reports to the joint ministerial committee. If a commercial dispute cannot be settled by consultations, there is provision for referral to an Arbitral Tribunal to be constituted by the joint ministerial committee. The main substantive provisions of the agreement deal with the scope and timing of tariff elimination, negative lists i.e. exceptions to the general process, the rules of origin, the treatment state trading enterprises, and safeguard provisions. Each of these is summarized briefly below.

Tariff elimination. Subject to important exceptions, provided they satisfy the agreement's rules of origin, India's basic commitment was to reduce tariffs on all products imported from Sri Lanka to zero over a three year period. This process started in March 2000, when import duties were removed on approximately 1000 (HS 6-digit) items and bilateral tariffs were reduced by 50 percent on another 3500 items. Tariffs on the latter group of items were reduced to zero in two stages over the following three years and eliminated in March 2003. When the agreement came into force, Sri Lanka eliminated bilateral tariffs on 300 items (mainly industrial raw materials) and cut bilateral tariffs by 50 percent on approximately 900 other items, and then to zero in March 2003. For another 2840 items, tariffs are being reduced to zero in three stages over eight years, by at least 35 percent in the first three years, and by at least 70 percent in the first six years.

Negative lists: India During the negotiations, both sides agreed to exclude a large number of products from the tariff reductions just described. There are 434 items on the Indian negative list. This is only about 8.5 percent of the India's complete set of HS tariff lines, but it includes products in which at first sight Sri Lanka appears to have a comparative advantage relative to India, at least in some specifications and varieties. Between them, the 434 products accounted for approximately 53 percent of Sri Lanka's total exports in 1999, but only 1.1. percent of India's total imports. In particular the negative list includes:

Garments (HS 61 and 62) which are by far Sri Lanka's largest and most dynamic exports. All garments were initially on India's negative list, but Sri Lanka was later able to negotiate a tariff rate

[29] Also commonly known as the India-Lanka Free Trade Agreement (ILFTA).A paper by Weerakoon (2001) provides a detailed breakdown of the agreement's import duty concessions .

[30] For an account of Sri Lanka's experience with trade liberalization during this period, see Authokorala and Rajapatirana (2000)

quota (TRQ) by which market access is allowed for 6.67 million pieces per annum at tariffs 50 percent below the general MFN rate e.g. in mid-2001, at 22.2 percent rather than the effective MFN rate of 40.4 percent. By January 2004 the general tariff on garments had been reduced to 20% so with the preference the TRQ tariff for Sri Lankan garments was only 10%. However, in 2000 the MFN tariffs for many garments in the lower price ranges were increased very substantially by setting minimum specific duties: in those cases the tariff on garments from Sri Lanka is half the specific duty. Other constraints are that 5 million of the 6.67 million pieces have to be manufactured from Indian fabrics, and that the Indian government can fix maximum sub-quotas of 1.5 million pieces for any category of garments, in addition to which the garments in question can only be imported through four specified ports.[31] The full tariff quota is equivalent to only about 2 percent of Sri Lanka's total garment exports.

Textiles (HS Chapters 50-60). The general situation is that there are no tariff preferences for textiles, with the exception of a list of products which have a 25 percent preference, and a limited number of other specified items with a 50 percent preference. In 2000, as were garments, the general MFN tariffs for a large range of textile products (including cotton and synthetic fabrics) were made subject to minimum specific duties.

Tea. This is another major Sri Lankan export industry: Sri Lanka is the world's largest exporter. India agreed to a TRQ under which annual imports of 15 million kgs of Sri Lankan tea (equivalent to about 3.8 percent of Sri Lanka's total exports, and approximately 2.3 percent of the Indian market[32]) are subject to a 7.5% tariff, with normal tariffs (in 2004 100%) applying to imports in excess of this. Imports can only be through four specified ports. In this case the preference is very substantial, but so far for reasons that are unclear, Sri Lanka's exports have been well below its quota.

Coconuts and coconut oil. Coconuts and coconut oil were excluded from the agreement: this was to ensure was no breach in the prohibitively high protection of the coconut/copra/coconut oil industry in Kerala. This industry developed after Indian independence in 1947, when competing imports from Sri Lanka and other countries (mainly developing countries in South East Asia) were first cut back and eventually excluded altogether by tariffs and QRs. For many years copra and coconut oil prices in India have been about double and as much as three times world prices. In 2004 the general coconut tariff was 70 percent and the coconut oil tariff was 85 percent.

Natural rubber. This is a long established but declining export industry in Sri Lanka. As with copra/coconut oil, in India after independence domestic prices were supported by cutting back on imports from the rest of the world, principally from developing countries such as Malaysia, Indonesia and Sri Lanka. This policy was implemented by the Indian Rubber Board in order to develop rubber growing in southern India, principally in Kerala. The Board also pays subsidies to rubber farmers. On average, for long periods in the past high tariffs and other protective measures kept domestic Indian prices for natural rubber (latex and smoked sheets) well above world prices. In 2004 there was still very high protection on latex (tariff 70%) but other natural rubber tariffs had been cut to 20%. However, rubber products including latex remained on India's ILFTA negative list.

Negative lists: Sri Lanka. There are 1180 HSC items included in the Sri Lankan negative list, equivalent to 26 percent of the 4534 HSC 6-digit items Sri Lanka imported in 1999. The negative list items accounted for to 56.5 percent of Sri Lanka's total imports in 1999, and for 25.5 percent of India's total exports. The negative list products are spread across the tariff schedule and include agricultural, intermediate, and manufactured products. Apart from politically sensitive agricultural

[31] Mumbai, Nhava Sheva, Chennai and Kolkata.

[32] Indian production and export data is available from the Tea Board India website <http//:tea.nic.in>.

products (e.g. rice, potatoes, and onions) and products which are important for government revenue (e.g. motor vehicles, tobacco and liquor), the other products in the negative list appear to mainly reflect the effectiveness of lobbying by local industries. 594 of the negative list products are food and agricultural items, 514 are manufactured products, and 72 are minerals, metals and fuels. Rice is a major Indian export, and onions are a potential exportable, but onion exports from India have in any case been prevented by export controls imposed to keep Indian domestic prices down. The Sri Lanka negative list also includes wheat and wheat flour, both of which India periodically exports.

Rules of Origin The local content requirement for preferential treatment is 35 percent i.e. the total value of the material inputs imported from other countries included in an exported product, should not exceed 65 percent of its f.o.b. value. If some of the raw materials or other inputs are sourced from the importing country, the minimum value addition in the exporting country is reduced to 25 percent, provided the cumulative value-addition is 35 percent, with a minimum of 10 percent occurring in the importing country. Alternatively, products are considered to be sufficiently processed and therefore qualify for preferential treatment, if they belong to a different 4-digit HS classification than the 4-digit HS classifications of all of the materials not originating in the exporting country. According to a study of Sri Lankan exports by Pitigala, about 57 percent of Sri Lankan exports would qualify under the 35 percent ROO criterion[33]. However, a large proportion of these are accounted for by tea, rubber, and copra/coconut oil, so that this rule plus the Indian negative lists exclude considerably more than half of Sri Lanka's exports from preferential treatment under the FTA. In particular, the value added ratio of most of Sri Lanka's garment exports are well below 35 percent, and to qualify they would have to import and use Indian fabrics. However, they would then run into the negative list constraints on garment and textile imports described above. A much larger range of Indian products would probably meet the 35 percent value-added criterion, but some –especially light engineering products-might have problems with the HSC-4 digit test, depending on how it is applied.

Safeguards If imports from the other country cause or "threaten to cause serious injury", after consulting with the other country the tariff preferences for the products concerned can provisionally be withdrawn while at the same time notifying the Joint Committee. If a satisfactory negotiated settlement cannot be reached within 60 days, the complaining country can permanently withdraw the tariff preferences. The agreement also allows the two countries to apply anti-dumping and anti-subsidies policies against each other in the normal way. India has a well developed and very active anti-dumping and safeguards regime (see Chapter 3) but there are no anti-dumping or safeguards laws in Sri Lanka.

Table 5.2

Indian Trade with Sri Lanka 1997/98-2002/03
$US million (current prices)

	Imports from	Exports to	Total trade
1997/98	30	489	519
1998/99	38	437	475
1999/2000	44	499	543
2000/01	45	640	685
2001/02	67	631	698
2002/03	90	921	1011

Source: Indian Ministry of Commerce (DGFT) website

[33] Pitigala, Nihal (1998)

One initial reaction to ILFTA was that the rules of origin combined with the negative lists required by India and the TRQs and other conditions that went with them, were too constraining and that the agreement would not provide significant export opportunities for Sri Lanka in India. In fact Sri Lankan exports to India expanded rapidly, doubling in the three years following the signing of the agreement (Table 5.2) and continued to grow at a rapid rate in the first six months of 2003/04. However, they remain very small : only about 10% of Indian exports to Sri Lanka, which increased by 44 % from a much larger base during the same three year period. The expansion of Sri Lankan exports has not involved any of the principal products on India's negative list (garment exports to India , for example, are practically nil) but in some cases this may have more to do with supply conditions on the Sri Lankan side and/or with competitive conditions in the Indian market, than with the TRQs and constraints imposed by India. For example, Sri Lankan tea exports to India have remained very small and well below its quota, despite the fact that they face a tariff of only 7.5% compared with the MFN tariff of 100%. Conversely, Indian exports to Sri Lanka have expanded very rapidly despite the large number of Sri Lankan products on its negative list. It is probable that most of the expansion has occurred in products already subject to low MFN tariffs in Sri Lanka, but this would need to be verified empirically. More also needs to be known about the extent to which direct investment has had a role in the acceleration of bilateral trade, especially direct investment by Indian firms in Sri Lanka.

From SAPTA to SAFTA?

From an early stage discussions among the SAARC countries have included the idea of eventually going beyond the exchange of trade preferences in a preferential trade area, to the abolition of intra-regional trade restrictions and tariffs, thereby creating a South Asian Free Trade Area, or SAFTA. This objective became explicit at the first meeting of the SAARC Council of Ministers in 1995, when it was decided to form SAFTA by the year 2001, but not later than year 2005. One reason given for accelerating the timetable for regional free trade, was that it would be a way of preparing for more global competition which would result from the new round of trade negotiations under the aegis of the WTO. In order to prepare, it was decided that the SAARC Council for Economic Co-operation (CEC) and the Inter-Governmental Expert Group (IGEG) should meet and discuss at length an action plan and terms of reference for SAFTA. The parameters set out for SAFTA in these discussions included the following:

- Tariff eliminations without any import restrictions;
- Removal of "structural impediments" to regional trade;
- Harmonizing of customs procedures and documentation;
- Banking facilitation;
- Port and transport facilitation;
- Facilitation of trade-related services;
- Establishment of a reviewing and monitoring mechanism; and
- Ensuring "equitable" benefits to all member countries.[34]

For the same reasons that SAPTA made very slow progress, for many years it was difficult to obtain unequivocal commitments to SAFTA, but finally, on January 6, 2004, at the Twelfth SAARC Summit held in Islamabad, the seven member countries of the SAARC signed a free trade agreement

[34] Under Article 9 of SAPTA, a "Committee of Participants" consisting of representatives of Contracting States meets at least once a year to review the progress made in the implementation of the Agreement to ensure that benefits of trade expansion emanating from the Agreement accrue to all Contracting States "equitably". The review of benefits is supposed to include an assessment as to whether the SAPTA tariff concessions and other concessions have provided "desired" levels of market access in an "equitable" manner as between countries.

which will go into effect from January 1, 2006. Under the trade liberalization component, the member countries agreed to gradually harmonize and eventually bring down their import tariffs on trade within SAFTA to the 0-5 percent range. Accordingly, in the first phase, the Least Developed Countries (LDCs) in SAFTA (Bangladesh, Nepal, Bhutan, and the Maldives) will reduce their maximum tariff rates to 30 percent within two years from the date of coming into force of the Agreement. The non-LDC members will reduce their maximum rates to 20 percent within the same time frame. In the second phase, which will resume on January 1, 2008, the non-LDC members will reduce their import tariffs to the 0-5 percent range in 5 years, while the LDCs will do the same in 8 years (Table 5.3). The described tariff reduction schedule may not apply to items on the 'Sensitive Lists', which are to be negotiated among the contracting members.

Table 5.3: Planned Phased Tariff Cuts on Intra-SAFTA Trade

	First Phase (two years) /a	SECOND PHASE /A	
	January 1-2006—January 1, 2008	JANUARY 1, 2008-JANUARY 1, 2013	JANUARY1, 2008-JANUARY 1, 2016
SAARC Countries:			
For LDCs: (Bangladesh, Nepal, Bhutan, Maldives)	Reduce maximum tariff to 30%		Reduce tariffs to the 0-5% range in 8 years. (Equal annual reductions recommended, but not less than 10%)
For non-LDCs: (India, Pakistan, Sri Lanka)	Reduce maximum tariff rate to 20 %	• Reduce tariffs to the 0-5 % range in 5 years; (Sri Lanka: in 6 years) (It is recommended that reductions be done in equal installments—at least 15 percent reduction each year)	
		• Reduce tariffs to 0-5 % for products of the LDCs within a timeframe of 3 years)	

/a: These phased tariff cuts for intra-SAFTA trade may not apply to items on each country's 'Sensitive Lists'.

The SAFTA Agreement has a number of positive features:

- Its political context reflects a desire to use stronger economic relations to reinforce improving political relations in the region, especially the key relationship between India and Pakistan. If it is effective economically, it should help improve political relations, and vice versa

- An effective SAFTA should be able to improve the South Asian regions' bargaining position in multilateral negotiations on trade with other regions and regional groupings

- Recent substantial cuts of industrial tariffs by India, and of both industrial and agricultural tariffs by Pakistan, indicate that trade liberalization is no longer feared by them as it had been in the past, at least for manufacturing if not for agriculture. If India and Pakistan lead the way in trade liberalization, both through unilateral actions as well as regionally through SAFTA, they will have a strong liberalizing influence on the trade policies of the other South Asian countries, especially Bangladesh.

- More radical and thoroughgoing regional trade liberalization than has been seen in the past, has the potential to give some impetus to dealing with a multitude of infrastructure deficiencies, institutional problems and various behind-the-border bottlenecks and issues which seriously hamper regional trade in South Asia.

On the other hand, in its current form, SAFTA has some major weaknesses, and it will have to face up to some difficult issues in the future:

- As shown in Table 5.3, SAFTA provides for back-loaded tariff cuts, particularly for the LDCs. There is danger that it may lose the momentum if the reductions take place over such long periods

- The "tariffs" for which a reduction program has been agreed are Customs duties only. But as discussed in this report, protective para-tariffs are also used by all the South Asian countries except India, and they are an especially important source of protection in Bangladesh. However, at this stage the agreement has no clear strategy for dealing with them, beyond requiring that they be notified and considered by the SAARC committee of experts.

- Under the agreement, all GATT -incompatible NTBs are to be eliminated on regional trade. However, as with para-tariffs, no mechanism has so far been established for dealing with NTBs beyond notification and consideration by the SAARC committee

- On the other hand, if high external protection levels for many sectors continues, faster and more drastic regional tariff cuts could lead either to substantial trade diversion and large economic welfare losses, or resistance to concessions, especially if the concessions would adversely affect highly protected industries (e.g. many of Bangladesh's import substitution industries) Both of these possibilities would in turn create pressures to put these industries on sensitive lists and exclude them from SAFTA.

- In this regard, agriculture (understood in the broad sense as including livestock fisheries and food processing industries) is especially important and politically sensitive throughout the region. There is no specific reference to agriculture in the agreement, but as noted in Chapter 3, agricultural tariffs in the region are much higher on average than industrial tariffs. In particular, most of India's industrial tariffs are already below the SAFTA target for a maximum tariff of 20% to be achieved between January 2006 and January 2008, but average agricultural tariffs in both India and Bangladesh are currently about 40% and have been rising in recent years, not falling. Likewise Sri Lanka's agricultural tariffs are also much higher than its industrial tariffs. In addition, as discussed in the chapters on agriculture and fertilizers in Volume II, agricultural subsidies and government market interventions are still very important in India's agriculture. All this suggests that agriculture will be especially difficult to deal with in the context of SAFTA, as has also been the case in other regional agreements e.g. the special treatment of agriculture under the EU Common Agricultural Policy, and in North America under NAFTA.

- The agreement is subject to a considerable degree of uncertainty due to the yet- to- be determined 'sensitive lists' of the individual countries. If the past experience of SAPTA is an indication, each country may present a long list of 'restricted' items that will not be subject to concessions. If these list are too long, they will quickly render SAFTA ineffective;

- The agreement provides for temporary suspension of concessions granted by individual members that are facing balance of payments difficulties. This is likely to create a significant element of uncertainty and could undermine the stability of SAFTA;

- The 'rules of origin' are crucial and still have to be negotiated

- The agreement seems to indicate that regional trade will continue to be subject to anti-dumping and presumably safeguard and countervailing duty actions by SAFTA members (in contrast to other RTAs –for example the EC-in which it is agreed not to use anti-dumping against firms in other member countries). This possibility also creates uncertainty and could be very disruptive for regional trade.

It is too early to tell how the future SAFTA negotiations will proceed. It is important, however, to stress that if the above cited weaknesses are not addressed, the SAFTA initiative may face the same fate as SAPTA. Regional free trade agreements could be "stepping stones" toward multilateral trade liberalization or global free trade; but, sometimes they may be "stumbling blocs" in the sense that they divert reforming energies away from the liberalization of trade with the rest of the world. There is also a real danger (exemplified by the European experience with the CAP) that the path of least resistance to regional agreements in agriculture will be external protection based on the highest, not the lowest common denominator of protection and subsidy levels in the individual countries. On the other hand, there are some substantial potential benefits from increased competition and scale economies, especially if lower cost exports from one or more SAFTA members are allowed to effectively compete with firms with higher production costs in neighboring countries. There is also the potential for firms to benefit from greater scale and to attract investment projects for which market size is important, including foreign direct investment . Removing regional barriers forces firms from different member countries into closer competition with each other, inducing them to make efficiency improvements. If SAFTA accelerates processes such as these, it could increase the confidence and interest of industry and government to lower tariff barriers against imports and increase the region's trading integration with the rest of the world.

Typology of PTA/FTAs

In the debates and negotiations on regional trade and economic integration in South Asia, political and foreign policy considerations have been dominant, and insofar as economic factors have had a role, they have been almost entirely mercantilist. That is, each country has been willing to trade off some preferential access to its markets for perceived diplomatic and political benefits, but subject to that, the objective has been to improve the access of its industries to markets in the other South Asian countries, while resisting and giving away as little as possible in preferential access to its own markets. These have also been the principal driving forces of the GATT and the WTO, and as history amply demonstrates[35], a process of mercantilist bargaining can lead to the progressive reduction of tariffs and other trade barriers. But in contrast to the world-wide scope of the bargaining that occurs within the WTO framework, the South Asian agreements involve countries in the region only, and one of their principal objectives and results is to divert imports from lower cost suppliers in other parts of the world to higher cost suppliers in South Asia. The free trade arrangement in South Asia will induce purchasers to switch demand toward supply from partner countries, at the expense of both domestic production and imports from non-members. This is trade creation and trade diversion. South Asian Governments would lose tariff revenue, and the overall effect on national income may be positive or negative, depending on the costs of alternative sources of supply and on trade policy toward nonmember countries. For instance, an FTA with India might shut out cheaper Chinese goods from the Bangladesh market unless tariffs are also reduced for them. For this reason it is important that policy makers and politicians be aware of the

[35] Hoekman, Bernard , Aaditya Mattoo and Philip English (eds) .2002.

consequences of regional policies for the economic welfare of their countries, but on this in South Asia there is so far little or no systematic analysis[36], and absolutely no recognition in the texts of the various agreements or in the general statements and discussions that have accompanied them. For example, no references will be found in the latter to consumer benefits, or the possibility of trade diversion costs, although government revenue losses have been the subject of negotiation.

How deep should regional trade liberalization be? The big gains from SAFTA are expected to come from regional integration of South Asian markets. Removing tariffs but leaving other impediments will inflict all the costs of revenue diversion without any of the benefits of competition and scale. *Thus deeper is better.* The agreement could cover border procedures where there is often large scope for illicit protection that undermines economic integration. Finally, as in EU, they can cover product standards, the simplest of which is mutual recognition. If a product can be sold in one country, it can be sold anywhere in the region.

Before concluding, however, we outline a framework for thinking about these issues. This distinguishes between: (a) Preferential trade policies which discriminate in favor of trade with other South Asian countries and against trade with the rest of the world; (b) Policies which do not overtly discriminate against trade with neighbouring countries, but which hurt trade with these countries proportionately more than trade with the rest of the world; and (c) Policies which directly discriminate against trade with other South Asian countries.

(a) Preferential trade policies which discriminate in favor of trade with other South Asian countries and against trade with the rest of the world. There is a large theoretical and empirical economic literature on the economics of regional trading blocs, which mainly deals with how the economic welfare of the participating states is affected by granting each other preferential access to their domestic markets, usually in the form of reduced or zero tariffs.[37] A number of general propositions seem well established in this literature:

- Unless the bloc as a whole has significant market power in world markets, free trade will maximize the bloc's economic welfare, and therefore policies which move the bloc towards free trade through general multilateral trade liberalization have greater welfare increasing potential than any regional preferential policies that leave the general level and structure of the bloc countries' protection against imports from the rest of the world unchanged.
- Even if the bloc has significant market power in some products, general trade liberalization with appropriate exceptions (tariffs or export taxes) for these products, will increase aggregate bloc welfare more than retaining the status quo modified only by regional preferential trade policies plus optimal import tariffs or export taxes.
- Whether regional trade preferences on balance increase or decrease the aggregate economic welfare of a bloc depends on the relative strength of trade diversion effects on the one hand, and increased competition and efficiency effects and economies of scale effects on the other. When one country allows a product to be imported from other bloc countries at zero or preferential tariffs which are lower than the general tariff rate on imports from the rest of the world, its customs revenues are reduced and its terms of trade are worsened, since imports are diverted from other countries to higher priced imports from the bloc countries. There are producer surplus benefits (exporter profits, higher tax receipts, higher wages etc) in the exporting bloc countries, but as long as there is no change in the

[36] A partial exception to the general lack of attention to the economic welfare consequences of regional preferential trade policies is a recent study by Mukherji (2000), who calculates the potential revenue losses of SAPTA preferences. He also estimated the economic welfare consequences of SAPTA in an earlier 1998 paper.

[37] There is a comprehensive discussion of this literature in the World Bank policy research report *Trade Blocs* (2000).

domestic price in the importing country, the costs exceed the benefits and there is a net reduction in the economic welfare of the bloc as whole. In effect, the reduced tariff revenue in the importing country is partly transferred to the increased producer surpluses in the exporting country, and partly used up in the excess cost of the preferential imports over the cost of the imports from the rest of the world that have been displaced. On the other hand, it is possible that the preferential imports will not only displace imports from the rest of the world, but also increase competition for domestic producers in the importing country and reduce prices there. The net effect on bloc economic welfare in this case then depends on the relative size of these effects. The net effect will still be negative if the customs revenue loss exceeds the increased producer surplus in the exporting bloc country plus the benefits of the reduced production costs and reduced consumer prices in the importing bloc country. But if the price reduction and the quantity of higher cost domestic production displaced are sufficiently large, the net economic welfare benefits to the bloc as whole may be positive. Another possibility is that the freeing of regional trade through tariff preferences will allow firms in the preferential region to increase their production and take advantage of unexhausted economies of scale, and in this way reduce production costs. This could happen if, as a result of preferential tariffs, a firm with unexhausted scale economies in one country is able to export to a bloc country and displace products which that country previously imported. Once again, the net effect on bloc economic welfare could be negative or positive. Economic welfare is reduced since lower cost imports from the rest of the world are diverted and customs revenue falls, but if the decline in unit production costs resulting from larger scale production is big enough, the producer surplus and/or consumer surplus benefits in the exporting and importing country may between them exceed this loss. Similar results are possible if competition from the regional firm with unexhausted scale economies drives out another or other sub-optimal scale firms, enabling it to take advantage of scale economies and generating producer and/or consumer surplus benefits. However, it is important to recognize the extent to which trade creating within-bloc efficiency improvements of this kind occur, or are allowed to occur, depends very much on the motivations and philosophies of the negotiators and the political background to the negotiations. If the scope of the agreement in terms of product coverage is not complete and is negotiable, and the philosophy of the negotiators is fundamentally protectionist, the negotiators are likely to resist giving tariff concessions on products that would lead to significant increases in competition from bloc countries for industries in their countries, but may be willing to give substantial tariff preferences if the principal effect is to replace imports from non-bloc countries with higher cost bloc production. In that case the overall net effect of the agreement on the economic welfare of the bloc will almost certainly be negative, even though some countries may gain.

- Preferential trade arrangements may concentrate certain kinds of production in some bloc members at the expense of others. Of particular concern to many countries is the possibility of the "deindustrialisation" of some bloc countries, with manufacturing industries leaving the poorer, least developed members and establishing themselves in industrial centres in the most advanced countries of the group. This kind of development could occur when all the all the bloc members protect capital intensive industries in which they are at a comparative disadvantage relative to the rest of the world, but the comparative disadvantage of the more advanced and higher income member of the group is less than the comparative disadvantage of the least developed and lower income members.[38] Then, if intra regional tariffs are abolished or reduced, capital intensive manufacturing firms may migrate to, and new firms establish themselves in the more developed country. This tendency may be strengthened if there are agglomeration economies from establishing in a larger and more developed industrial region. The capital intensive firms in this region may still be less efficient than the equivalent industries in the rest of the world, and need protection against imports, but if their products are exported to the less developed bloc countries with low or zero duties while high tariffs are still applied in those countries to competing imports from the rest of the world, there may be little or no

[38] For a discussion of these possibilities see Venables (1999).

benefit to the consumers of the low income bloc countries while at the same time they lose the producer surpluses that were previously generated by the firms that have now migrated.

(b) *Policies which do not overtly discriminate against trade with neighbouring countries, but which hurt trade with these countries proportionately more than trade with the rest of the world.* As noted earlier in this paper, for many years all the South Asian countries followed import substitution policies which used a combination of discretionary import licensing and very high, effectively discretionary[39] tariffs to exclude practically all imports unless they were judged to be "essential" and unavailable from domestic sources. In India, this was reinforced by the general ban on imports of all consumer goods, and the "canalization" of imports of agricultural and mineral commodities by parastatal import monopolies. One effect of these policies was to almost entirely exclude imports from neighboring South Asian countries and to confine most imports to machinery and intermediate materials most of which came from developed countries and later on from East Asia, and to petroleum, petroleum products, minerals and some agricultural commodities (e.g. edible oils) not produced in sufficient quantities in South Asia. Starting in the 1980s, these policies were reversed in the peripheral South Asian countries, and during the 1990s this showed up in rapidly increasing imports from India. Import policies in India were liberalized after 1991 and the general consumer good import ban was finally phased out in April 2001. But despite recent substantial reductions in industrial tariffs, Indian protection of many products of potential export interest to its neighbors remains high, with minimum specific tariffs applied to textile fabrics and garments which are explicitly aimed at preventing or limiting low value imports of these products, many extremely high agricultural tariffs, and imports of major agricultural commodities such as wheat and rice remaining under the sole control of parastatals or designated legal private monopolies. While these policies continue, export opportunities in India for India's South Asian neighbours are likely to remain limited and a large proportion of Indian regional imports will continue to come through informal channels, either bypassing Customs controls altogether, or with the connivance of Customs officials.

(c) *Policies which directly discriminate against trade with other South Asian countries.* The most obvious and important example of this is the India-Pakistan trade relationship i.e. the Pakistan ban on all imports from India except for products on Pakistan's positive list, and the measures on both sides which restrict transport links, business travel, and business contacts of all kinds. It is obvious that the removal of this discrimination would increase economic welfare in both India and Pakistan. With the removal of the Pakistan import ban, Indian products that would now be exported to Pakistan would create increased producer's surpluses in India which would be divided between increased business or farm profits, tax revenue and labor incomes. If these new Indian imports into Pakistan only partially replace Pakistan imports from the rest of the world and do not affect prices in Pakistan, there would be no change in economic welfare in Pakistan. But more likely, because of the marked transport cost advantage of Indian imports, especially products exported from the north-west regions of India to northern Pakistan, some products or product varieties imported from the rest of the world would be replaced entirely and Pakistan prices would fall, with corresponding economic welfare benefits in Pakistan. For example, periodically (as during 2000/2001) Pakistan imports wheat from world markets while there are large surplus stocks nearby in India that are more than sufficient to cover the Pakistan supply deficit. 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. Conversely, the removal of India's travel and other restrictions on trade with Pakistan which are the *de facto* indirect counterpart of Pakistan's direct import restrictions, would

[39] If an import license were granted, otherwise prohibitively high tariffs were generally reduced, but often just for the importer receiving the import license.

increase economic welfare in Pakistan via new exports to India, and would either leave economic welfare in India unchanged, or would increase it insofar as prices in India fall and/or the range of available product varieties improves. It is probable that some part-possibly large- of the increased trade would be goods that are already traded shifting from informal to formal channels, but there would still be economic welfare increases associated with this change, since it would not occur unless the net benefits to the trade participants are higher using the formal channels. For the trade that shifts, the net benefits are likely to include reduced transaction costs and the replacement of some smuggling rents by government revenue from import tariffs and other taxes.

Concluding Remarks

Thus the potential for increased regional trade that is not welfare-reducing is not very great in South Asia, compared to 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. This shows up in various statistics and indicators including:

- Trade intensity modified by geographical proximity
- Low correspondence between South Asian exports with revealed comparative advantage and South Asian import demand
- Low correspondence between the principal exports of the South Asian countries to ROW and their principal exports to other South Asian countries

For all these reasons the South Asian countries would do much better economically if they were to increase their trading integration with the rest of the world rather than pursuing 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.

Insofar as regional preferential trade arrangements continue and become effective, a South Asian country that liberalizes and moves to lower general (mfn) protection levels (e.g. a peripheral 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. But it is probably unlikely that this will actually 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 peripheral countries 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 the more highly protected RTA members.

At the end of the day, ***trade blocs are political.*** Trade blocs proliferated during the 1990s.. By 1999, more regional agreements had been notified to the WTO than it had countries as members. Evidently, there were powerful forces driving the process. Regional cooperation on trade issues (e.g. SAFTA) may help countries to cooperate on other issues. Small neighboring countries on India's borders have plenty of scope for cooperation. Some infrastructure, such as power, telecoms, and railways, may be better provided regionally than nationally. Thus, even if regional cooperation starts with trade issues, it is unlikely to stop there. The main benefit from cooperation on trade issues may be the development of a habit of trust and cooperation between neighboring governments that can then be extended to issues on which there is more scope for mutual gain.

Chapter 6: Conclusions and Recommendations

Dominant role and influence of India. India accounts for approximately 80 percent of the combined population, GDP and trade of the South Asian countries, and most of the regional trade (both formal recorded trade and unrecorded trade) is bilateral trade between it and individual South Asian countries. Because of their common history, institutions and continuing contacts, except in Sri Lanka, what India does on trade policy also has a very considerable influence in the other countries. In particular, were India substantially to liberalize its trade policies during the next few years, its action would be sure to have a major impact and to reinforce trade liberalization in the countries around it. On the other hand, restrictive trade policies in India (such as its current anti-dumping policies) increase the probability that other South Asian countries will adopt the same or similar policies. Therefore, initiatives to reinforce trade liberalization in India have an extra indirect benefit through their likely favorable regional impact. Neither liberalizing nor restrictive trade policy changes in the other South Asian countries, however, are likely to influence India. Therefore, a work program aimed at reinforcing trade liberalization in South Asia should give India first priority. Table 6.1 presents a summary of trade policies in the region.

Given the by-now overwhelming accumulation of evidence across the globe suggesting that over the long haul trade openness is a more trustworthy friend of the poor than protectionism, India and its neighbors should welcome further liberalization. Hardly any evidence shows that a country has achieved rapid growth without expansion of trade. On the other hand, trade reform is only a necessary condition, not a sufficient one, for an improved growth performance. Reaching that goal requires other complementary policies, such as de-regulation, effective anti-corruption efforts to improve governance, upgraded infrastructure services, and an improved overall investment climate.

The considerable and commendable progress made in South Asia in recent years toward opening long-protected markets and redirecting incentives away from import substitution toward export competition signals how much can be done. Much more remains to be done. The recommendations that follow do not underestimate the challenges policymakers and publics face. They are meant, though, to help guide an undertaking that gets no easier the longer it is postponed.

Non-tariff barriers to imports

Since India phased out its last QRs in April 2001, Bangladesh is the sole holdout in South Asia using these traditional devices, some with the explicit purpose of protecting local industries. By itself, that lonely distinction should strongly suggest to Bangladeshis the losses they incur the longer they retain QRs. In addition, though, India, Pakistan and Sri Lanka have done away with QRs except in regulating agricultural and food imports with sanitary and phytosanitary controls, all South Asian countries also still impose non-tariff barriers of various sorts.

A major exception to the move away from explicit QRs is Pakistan's positive list of 600 items which can be legally imported from India. Nothing can be legally imported into Pakistan from India except for the products on this list. 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.

Table 6.1
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-	2	3
Range of CD slabs> normal	40-210%	40-250%	tariffs & VAT	75 &100%	40, 80, 130%
% of ad valorem tariff lines >normal CD rate	2	0.1	exemption for extra	0.2	5.2
% of tariff lines with specific duties	5.3	0.9	protection	[illegible]	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.

India's general policy subjecting the import of *all second-hand goods* (including industrial raw materials and machinery) requires some kind of special procedure or import licensing. The restrictiveness of these controls varies from product to product, and many of the restrictions are justified on grounds of health, safety, security, consumer protection etc. and involve obtaining permits from various Ministries and other organizations in order to clear Customs. Like India, Pakistan also bans or restricts the import of a number of second hand products for which there is certainly a substantial domestic demand.

Although all of India's and some of Pakistan's restrictions on second-hand goods are (or are claimed to be) WTO-compatible, the real and dominant motive for many (often quite explicit in published regulations) is the protection of local industries. Some examples:

- Used clothing : banned in India but allowed in all the other South Asian countries
- Second-hand cars: banned in Pakistan and restricted in India (where there are heavily protected auto industries) but allowed in the other South Asian countries where there is no auto production.
- Various kinds of second-hand industrial machinery: banned in Pakistan and subject to import controls in India (in order to protect their engineering industries) but generally allowed in the other South Asian countries.
- Second-hand household machinery such as refrigerators, air conditioners etc. is banned in Pakistan, restricted in India, but permitted in the other South Asian countries
- Used and retread tires: banned in Pakistan, restricted in India, permitted in the other South Asian countries
- Plastic scrap: banned in Pakistan, importable in India but subject to restrictions, permissible in the other South Asian countries.

Recommendation: These residual controls would not remain in place unless they involved important domestic economic and political considerations. Formally, they are WTO-consistent. But given the past history of the region and still strong protectionist impulses, policymakers should undertake objective analyses of the costs and benefits of applying these measures for much longer.

Tariffs

At present the general maximum customs duties that apply to most but not all products in the South Asian countries are as follows: India, 30%; Pakistan 25%; Bangladesh 25%[1]; Sri Lanka 25%; Nepal 40%; Bhutan 30%. A major improvement on the situation 10 years ago when tariffs in all these countries were much higher, change has brought an additional, great simplification of the structure of tariffs with far fewer tariff bands. Most countries in the region now have 3-5 of them as opposed to 15 or more in the early 1990s.

Recommendations: Nonetheless, the many continuing problems with tariff policies suggest that a reform agenda for the future should include:

- *Further substantial "tops down" reductions in the general level of tariffs*. The process for tariff reductions used in the past in India, Pakistan and Bangladesh and apparently envisaged for India over the next two years has been "tops down" (reductions in maximum tariffs) and has worked very well. The "tops down" process has, as intended, squeezed processing margins and created more uniform as well as lower tariff structures. As a policy (especially if announced in advance) it has the advantage that it is simple and easily understood. ***This trend should be maintained for all of South Asia.*** Although there is a danger with this process that lower-level input tariffs will also be reduced, thereby

[1] This was reduced from 30% to 25% in the FY05 Budget announced on 10 June 2004.

maintaining effective protection levels, government revenue concerns and pressure from local producers of intermediates have limited the extent of such occurrences in South Asia.

- *Try to contain pressures for high agricultural tariffs*. These pressures are most apparent in India, where average agricultural tariffs are now well above non-agricultural tariffs, and where -- at the first sign of import competition -- large tariff increases have become routine. However, similar tendencies are also apparent in Bangladesh for a variety of fresh and processed foods and in Sri Lanka for rice and some other large import-substitution crops.

- *Move towards more uniform tariff structures*. Tariffs in South Asia are still highly escalated; they rise along with the degree of processing, although the reduction of the top rates has substantially reduced the variance of effective and nominal protection. Government officials, businessmen and politicians on the whole seem to believe that this built-in escalation is the appropriate structure despite many empirical studies in all the South Asian countries during the past 20 or more years that have demonstrated the highly distorted and economically inefficient patterns of effective protection that tariff structures based on this principle create. Accordingly, as suggested above, the main thrust of tariff policy should be to press ahead with "tops down" tariff reductions, gaining further reductions in the variance of effective protection as a logical by-product.

- In arguing this case for this policy, the main points likely to be most easily understood and accepted by the official-business-politician groups that will need to support or at least accept the changes are: (1) local industries need low tariffs to be internationally competitive; (2) low tariffs level 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; and (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 interest in low tariffs -- as distinct from the interests of intermediate business consumers -- has practically no weight in discussions and negotiations on tariff levels.

- *Reduce and if possible eliminate the use of exemptions and partial exemptions from standard tariff rates*. This practice is 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 who negotiate and recommend the exemptions. Removing the remaining tariff exemption culture should be attacked directly and should be a normal part of Customs administration reform. Progress would be much easier if the demand for exemptions were reduced by cutting the general level of tariffs. Recent experience in Pakistan shows that "tops down" tariff reductions that also involve reduced raw material, intermediate input. and machinery tariffs will eventually substantially reduce the demand for tariff exemptions.

The number of basic rates has certainly been reduced substantially as the top rates have come down, and there are probably far fewer exemptions and partial exemptions than during the 1980s. But in India, Pakistan and Bangladesh there are still far too many: for example the 2002-03 Indian "Jumbo Exemption" Customs notification lists 415 items for which some kind of exemption is allowed, each item corresponding to an HS code (two digit, four digit, or six digit) and many supplemented by one or more of 43 detailed product lists, which contain over 1100 detailed product descriptions.

The vast majority of these exemptions are for intermediate material inputs or for machinery and equipment items including spare parts, and may involve one, two or all three of the basic customs duty, the additional (domestic VAT) duty, and the Special Additional duty (SAdd). The exemptions are

sometimes for specific subcategories of HS codes, for use as inputs in the production of specified products, for use by particular firms or industries (but not by other users of the same products), or even for particular (non-preferential) foreign supplying countries. The Indian "Jumbo Exemption" notification was introduced in 1996 to consolidate and bring greater clarity to the previous impenetrable maze of exemption notifications, but since then the Jumbo has grown, and the total number exemptions now appears to be about double the number in 1996.

Of the many continuing exemptions in Pakistan, a large number are associated with "indigenisation" or local-content programs in the engineering industries, which the government is phasing out. These exemptions have also become less attractive as tariffs on intermediate materials and components have declined.

The situation in Bangladesh is obscure: notifications (SROs) about non-export related exemptions are not consolidated in any one place, and their impact is further complicated by the number of taxes on imports (currently four) for each of which exemptions could in principle be given. It is reported that in practice exemptions and partial exemptions are negotiated individually at Customs, and many may not be systematically recorded in Customs service records. Consequently, in Bangladesh it appears that there is hazy and ill-defined boundary between legal exemptions formally agreed to by Customs and the many unrecorded, illegal ways to avoid Customs duties.

The frequency of exemptions in Sri Lanka, Nepal and Bhutan has not been investigated, but is reported to be much lower than in India, Pakistan and Bangladesh, principally because most intermediate input tariffs and machinery tariffs are low (zero, 5% or 10%) so that there is less to be gained by negotiating for tariff exemptions or reductions. During the 1980s and before, the granting of exemptions from normal tariffs was a normal accompaniment of successful lobbying for an import license and -- like import licensing -- was a major nexus of rent seeking and corruption throughout South Asia.

- *Use WTO tariff bindings to tie in liberalizing reforms.* As required by the WTO Agreement on Agriculture, India, Bangladesh, and Sri Lanka have bound all their agricultural tariff lines. Pakistan has bound about 90 percent of them. Except in Sri Lanka, which bound at 50%, most of these agricultural bindings are prohibitively high (100%, 150% and 300%) and fail, for practical purposes, to constrain the levels of the corresponding applied tariffs. As regards non-agricultural tariffs, India has currently bound 68.2% of its non-agricultural tariff lines, most at 40% and a smaller proportion at 25%. However, the 32% or so of unbound non-agricultural tariff lines are for products where protectionist lobbies are especially strong: textile fabrics, garments, steel, automobiles, e.g. Pakistan and Sri Lanka have respectively only bound 27.5% and 8% of their industrial tariff lines; Bangladesh has bound practically none (50 lines or 0.9% of the total). Most of the Pakistan and Sri Lankan bindings are well above (more than double) current applied rates and consequently leave considerable scope for substantial tariff increases, if they so chose.

Overall, then, except for some of the Indian bindings and some Pakistan bindings of textile tariff lines, the South Asian countries have not benefited from their WTO membership by binding their reduced industrial tariffs and thus protecting themselves from future backtracking. If India goes ahead with its announced tariff reductions over the next few years and further tariff cuts are made in Pakistan, Bangladesh and Sri Lanka, the WTO tariff-binding facility will become even less relevant unless many more tariffs are bound and existing bindings are substantially reduced.

A possible forum for negotiations on WTO bindings could include SAPTA, where there should be a mutual interest in obtaining commitments that SAPTA tariff preferences will not be made meaningless by future MFN tariff increases. Bangladesh, for example, could ask that India bind tariffs for which Bangladesh receives tariff preferences under SAPTA and vice versa. Additionally, continuing

efforts should be made to remind the South Asian trade policy communities of the obvious advantages to their countries of the WTO binding facility in (i) protecting liberalizing reforms against future pressures to reverse them; (ii) providing a more certain environment for trade and investment, including direct investment by foreign firms that want assurances against arbitrary tariff increases' undermining their investments; (iii) the extreme unlikelihood that the present value of improved export access in the future as a result of tariff bargaining would outweigh the present value of the annual economic cost of keeping high unbound tariffs.

Other import taxes and levies

At present India, Bangladesh, Sri Lanka, and Nepal employ protective taxes on imports in addition to Customs duties. The practice is a major problem in Bangladesh, where three other protective taxes presently provide very high levels of nominal tariff protection to local producers in distinctly non-transparent ways. Because of import taxes other than customs duty that have protective implications, Bangladesh and India currently have de facto general maximum protective tariffs of 34 % and as high as 100% (in agriculture), respectively.

Moreover, in all the South Asian countries the share of revenue collected from purportedly trade-neutral import taxes 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, the taxes are broadly neutral and do not favor domestic production, this development is highly desirable. However, if tax collection in the domestic economy is less comprehensive and rigorous on domestic production than on imports, the so-called trade-neutral tax may operate to an unknown and probably haphazard extent as another protective import tax.

Recommendations:

- In the interests of transparency and efficiency, eliminate protective import taxes (other than customs duties) applied in India, Bangladesh, Sri Lanka, and Nepal. *Especially in the first two countries, these holdovers from a protectionist past put into question the seriousness of commitments to openness in trading. The sooner they are discarded, the more rapidly can the private sector adjust to integration into global markets, can governments reduce revenue leakage, and importers gain from a simplified and transparent tariff schedule. Pay special attention to the potential protective effects of domestic taxes collected both on imports and domestic production.*

Policymakers should conduct further systematic investigation in all the South Asian countries to see whether and to what extent some of the reductions in protective tariffs may have been vitiated by inefficiencies in collecting indirect taxes such as VAT. At present the shares of imports and domestic production in indirect tax revenues are generally not reported: this distinction should be routinely made and trends monitored. The same applies to other taxes on imports and domestic transactions, such as the advance income taxes used in Pakistan and Bangladesh.

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.

Recommendations: The present momentum of anti-dumping in India could be stopped or slowed by pursuing some or all of the following policy choices:

- *Repealing the AD law and using the safeguards provisions as the main safety valve for responding to protectionist pressures.*

- *Channeling all or most cases to the safeguard route and maintaining it as a temporary 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 so as to make predatory pricing and the likelihood of subsequent market power preconditions for the imposition of AD measures.*

An unfortunate consequence of anti-dumping activity in India is that producer groups looking for ways of obtaining extra protection in the neighboring South Asian countries are using India's example as another reason why their governments should introduce AD laws and develop the technical capacity to implement them. In these discussions, economic costs 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 in providing technical assistance to establish AD capabilities in developing countries abet these domestic pressures.

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 the background necessary for eventual public questioning of AD in India and be salutary as well for other South Asian governments presently under pressure to go down the same path.

Special protective treatment

In all the South Asian countries the announced, "maximum" general Customs tariffs are not actual maxima. In addition to and apart from the use of other protective import taxes on top of Customs duties, every country has industries that receive special high-tariff treatment. Many of these industries are large and have a public-sector production and/or regulatory presence. They often also benefit from exemptions from input tariffs, NTBs of various kinds, and subsidies. As a result, if weighted by domestic production protected, average tariffs in most of the South Asian countries (especially in India) would be considerably higher than unweighted averages of tariff lines. Since they would rise as well above import-weighted tariff averages, where high tariffs reduce or keep out imports, they therefore systematically understate the extent to which tariffs are protecting domestic industries.

As elsewhere, a number of industries in South Asia receive special treatment in various forms from government. In addition to NTBs of various kinds, protection can come from especially high tariffs that exceed the country's highest normal tariff band, from a combination of high-to-moderate output protection and especially low-input protection, from direct and indirect subsidies, and by other means. By definition, since the industries receive special treatment, an influential interest is always involved, one which will have to be dealt with in any thoroughgoing trade liberalization process. A partial but by no means comprehensive list of problem industries in South Asia is given below.

In compiling the list only the following relatively large industries have been included: (1) real "eyesores" (such as Pakistan Steel, the Pakistan auto assembly industry, the steel and urea fertilizer industries in India) which have stood out and are widely recognized as problems, and where substantial

adjustment and restructuring would have to occur if protection were reduced and subsidies were removed; (2) industries which are not "eyesores" in this sense but where open trade policies would involve substantial adjustments even though after adjustment a large part of domestic production would probably survive and prosper (e.g. the Indian auto industry); (3) industries in which the countries may have a basic comparative advantage but where some influential domestic interests oppose import competition or the removal of subsidies, even though the industry as a whole would be strengthened and benefit (e.g. the Indian textile and garment industries) (4) "commodity" industries in which the industry may or may not have a comparative advantage but where world markets are cyclical and the industry has successfully lobbied for measures that protect it during downturns and limit the extent to which it has to adjust to these cycles e.g. various agricultural products but also petrochemicals and synthetic fibres.

India

- Foodgrains
- Oilseeds and edible oil processing
- Sugar
- Milk and milk products
- Tea and coffee
- Natural rubber
- Basic steel
- Copper, lead, zinc
- Petrochemicals
- Fertilizers (urea)
- Synthetic fibers
- Automobiles
- Some auto components
- Textile fabrics
- Garments

Pakistan

- Sugar
- Oilseeds and edible oils processing
- Basic steel
- Fertilizers
- Automobiles
- Some auto components
- Some engineering industries
-

Bangladesh

- Sugar
- Jute textiles
- Oilseeds and oilseed processing
- Textile fabrics
-

Sri Lanka

- Rice
- Potatoes

Nepal

In many of these industries the strongest resistance to policy reform comes from public sector firms and government ministries and departments which oversee the PSUs and the industry generally. Prominent and well known examples in India are:

- Steel: the public sector firm SAIL (Steel Authority of India) and the Ministry of Steel
- Fertilizers: the Department of Fertilizers in the Ministry of Chemicals and Fertilizers
- Petrochemicals: the public sector firms Oil and Natural Gas Corporation (Exploration), Hindustan Petroleum Corporation Ltd, Bharat Petroleum Corporation Ltd, Indian Oil Company (Refining and Distribution), and the Ministry of Chemicals and Fertilizers
- Textiles and garments: the public sector firm National Textile Corporation, the Cotton Corporation of India, the Ministry of Small Scale Industries, and the Ministry of Textiles
- Auto industry: 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 local content ("indigenisation") program)
- Natural rubber: the Rubber Board
- Food grains: the Food Corporation of India (FCI), the National ....(NAFED), the Ministry of Agriculture, the Ministry of Food and Civil Supplies (responsible for the Public Distribution System), and various state government agriculture ministries and organizations.
- Edible oils and oilseed processing: Ministry of Agriculture and Ministry of Food Processing.

The most difficult problem for reform in these cases is when large public sector firms would have trouble adjusting to liberalization, especially when large and influential workforces are involved. One example is the National Textile Corporation (NTC) in India, a public-sector holding company which employs over 100,000 workers in about 120 textile mills, all of which were bankrupt when NTC took them over many years ago. It continues to operate most of these mills with government subsidies, and cross subsidies from a number of mills which it has been able to return to profitability. 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 close down and sell off the assets of patently unviable NTC mills have either not been pursued or explicitly rejected (most recently in 2000 at Cabinet level). Another example in India is the Steel Authority of India (SAIL) which operates five integrated steel mills, some of which would not be viable with open competition, and has a total, significantly inflated workforce of 147,600

Another difficulty for policy liberalization are line ministries and other government entities with long established bureaucratic interests in industry controls, and which also usually have ministers with political constituencies related to the industry. 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. Since 1999 the Ministry has been in charge of a "Technology Upgradation Fund" scheme, which aims to help the industry face up to the MFA phase out and the April 2001 removal of India's remaining textile and garment QRs. However, as this activity illustrates, unless there are some basic changes in the culture of the bureaucracy, what is done in the name of "development" may reflect old mindsets that distrust and don't understand market solutions. They may slow down or prevent the abandonment of old regulatory controls while the developmental reforms introduce new types of planning and regulation which involve if anything an expanded role for the bureaucracy.

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 declined. The decline was less than proportionate to the reduction in tariff rates, because the share of imports in GDP grew. But by 2001, 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, all the governments were much less dependent on tariffs than they had been 10 years before. Subject to a caveat discussed below, much of this highly desirable lessening of public finance dependence on tariff revenue has been due to the introduction of VAT-style indirect taxes and the gradual extension of their scope and improvements in the efficiency with which they are administered. In India in the past few years there has also been a major expansion in revenue collected from individual and corporate income taxes.

Given this past and continuing success in reducing governments' financial dependence on import tariffs, further substantial tariff cuts should not be too difficult to manage in India, Pakistan, and Sri Lanka. Import duties now account only for approximately 7, 12, and 11 percent respectively of the total consolidated government revenues of these three countries. As in the past, in India and Pakistan especially, part of the shortfall would also come from the resulting increase of imports in GDP. Some idea of the potential in this regard is provided by China which has an economy more than double India's and about 10 times the size of Pakistan's and is therefore likely to be less open. Despite the much greater size of its economy, in 2001 China's import/GDP ratio was about 21 percent, compared to 10.9 percent in India and 14.7 percent in Pakistan.

The public finance consequences of further tariff reductions might be more difficult to manage in Bangladesh and Nepal, however. Protective import duty revenues there are currently around 22 % and 25 % of total government revenues, respectively, and 36% and 41% of total indirect tax revenues. On the other hand, smuggling that is truly clandestine or that is accomplished through bribery of Customs officials is generally recognized to be a proportionately much bigger activity in both these countries than in India, Sri Lanka, and (in present circumstances) Pakistan. Such contraband usually escapes all types of domestic taxes (direct and indirect) as well as protective and domestic taxes imposed at Customs points. Consequently revenue losses from tariff reductions are likely to be offset at least partly by the diversion of some of this illegal un- or under-recorded trade into legal channels. Even so, more than in the other three 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.

Efficiency in the administration of domestic taxes is also important because these taxes are generally more easily collected by the Customs service on imports than by indirect tax administrations from businesses in the domestic economy. For example revenue from the Pakistan sales tax (a VAT-type tax) on imports is currently almost 60 percent of total economy-wide collections from sales tax. Part of this very high share of collections from imports in total net collections can be explained by the VAT feature which allows users of imported intermediate inputs to claim subsequent credits. The high share also raises the possibility that sales tax on domestic transactions may not be as effectively collected as sales taxes on imports. If this is true, part of the sales tax on imports may in fact be acting as a protective import duty, but probably in a haphazard way depending on which industries and firms in the domestic economy avoid some or all of the tax.

A similar issue attaches to "advance income taxes" (AITs) on imports in Bangladesh and Pakistan. These are withholding taxes that can be credited against corporate or personal income taxes. The tax rates are presently 3% of the cif price in Bangladesh and in Pakistan 6% of (cif+customs

duty+sales tax), equivalent to rates of between 7.2% and 8.6% of the cif price for Pakistan's normal customs tariff "slabs" of 5%, 10%, 15% , 20% and 25%.

In Pakistan this is a minimum tax; no refunds are given if the income tax liability of the importer turns out to be less than the advance income tax, although it can be used as tax credit if the income tax liability is greater. Clearly, if domestic producers competing with the import avoid all or part of their income taxes, or if they make losses or pay correctly assessed income taxes which, in relation to their selling prices, are lower than the AIT rates on competing imports, the AIT would also act as a protective import duty. For these reasons, to monitor how fast and effectively the South Asian countries are in fact freeing themselves from their dependence on protective import duties, it is 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 scrutiny should be a normal part of IMF and Bank monitoring of the tax and public finance situations South Asia and that the finance ministries be asked to focus on this aspect of their tax policies by distinguishing and regularly reporting the breakdown of the various taxes that are collected by Customs. Except in India, all this data has been collected but most countries do not publish it. In India, the different taxes collected by Customs were apparently not available in aggregated form even internally until fiscal 2001/02. To put the newly published Indian data in perspective and to analyze trends, it would be useful to check on the estimates for earlier years given in this report (Table III.2).

Performance by Country

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. All can benefit from reducing the number of tariff bands and lowering tariffs – beginning with the highest – but to different degrees. Those or other steps may be among the most productive trade reforms in Sri Lanka, where liberalization has already made significant progress. They might, however, make less impact where, as in India and Bangladesh, import taxes and levies have multiplied as tariffs dropped, providing substitute revenue but often replacing old, transparent trade barriers with new, discretionary ones.

To assess the region's state of progress, therefore, this section looks at the practices of the different country, beginning with Sri Lanka, the most advanced, and ending with India, the most complex.

INDIA: Accounting for about 80 percent of the combined population, GDP, and trade of the South Asian countries and most intra-regional trade, India leads in many areas of economic policy and performance – but not in trade reform. Suggesting that liberalization may be reviving, however, India's 2002-03 budget cut the basic maximum customs duty from 35 percent to 30 percent in the 2002/03 budget, and officials announced a further reduction to 20 percent over the next two years. Should India energetically embrace trade reform, it may provide a decisive stimulus to progress throughout the region toward greater openness and trade-fueled economic growth. For the time being, however, it provides its neighbors a model for restrictive policies that some may be driven to emulate. Details of its protectionist regime have been discussed above and will be again in the following section on key sectors.

Under every policy heading – and despite reform efforts between 1991 and 1997 -- India's trade barriers are the highest in the region, the least transparent and the most diverse. For example,

- There has been a major reduction in the average Indian *ad valorem* tariff since 2002/03, which has come down from 35% to 22.2%. Whereas previously Indian tariffs were much higher than tariffs in the other South Asian countries, on average they are now well below Bangladesh's

tariffs, and only about 3 to 4 percentage points higher than tariffs in Pakistan and Nepal. India now ranks 12th among 139 countries in terms of average tariffs, and 5th in terms of agricultural tariffs.

- Although it phased out a large number of QRs protecting consumer goods during the 1990s, it raised many industrial import tariffs; made anti-dumping a major activity, imposed specific duties to protect the textile and garment industry, used local-content (TRIMS) arrangements in the auto industry, and, especially since 1997, substantially increased tariffs protecting major agricultural products and agro-industries.

- Including zero, India is currently using 7 normal Customs duty rates, but with many products subject to higher and lower "additional" duties than the standard 16-percent rate, there are in practice a large number of total protective import tax slabs (41 in 2002/03) associated with the seven "normal" Customs duty slabs.

- About 80% of its tariff lines now have the general maximum customs duty of 20%, though most agricultural tariffs are bunched around 30%.

- Inclusive of specific duties, India has the largest number of tariff peaks -- lines with basic Customs duties that exceed the general maximum rates – in South Asia, especially tariffs protecting its agricultural, textiles and garments and automobile sectors.

- The recent indications that serious trade liberalization is resuming appear to exclude agriculture. State trading monopolies still control the import and export of most agricultural commodities, including the major foodgrains. Agricultural tariffs have risen even as the average level of industrial tariffs has been declining to the point that in 2001/02, India's unweighted average agricultural tariffs (including tariffs on processed foods) were exceeded by only three other developing countries, South Korea, Turkey and Morocco.

- Even negotiating a major reform step with the US and EU to phase in lower tariffs and remove import licensing in the field of textiles and clothing, India reserved the right to revert to 1990 policies that banned imports and imposed tariffs of 110 percent or more if WTO liberalization efforts stalls, reaffirmed its right to restrict textile imports under the GATT balance of payments provision, and excluded from the US/EU treaties most cotton fabrics, which account for the bulk of Indian fabric production, and about half the apparel tariff lines, making no commitment to extend coverage in the future.

- Although, since April 2001, India no longer explicitly uses conventional import licensing to protect domestic industries, it continues to employ various GATT-compatible controls to shield against competition. In November 2000, apparently anticipating significant import flows after the last QRs were phased out, officials made a certification of Indian quality standards and accompanying standard mark mandatory for imports of 133 products and product groups[2] not subject to such compulsory treatment. Although the Bureau of Indian Standards (BIS) asserts that this certification scheme operates in "in an impartial, non-discriminatory and transparent manner," the new regulation has effectively shut out all "off –the –shelf" foreign supplies of steel from the Indian market since foreign suppliers must, among other conditions, set up a liaison or branch office in India, pay for the cost of a certification visit by a BIS technical team to the foreign supplier's factory, and pay an annual "marking fee" of $US $2000 plus one percent of the invoice price of products shipped to India.

[2] The 133 products and product groups include food ingredients, powdered milk and other milk products, cements, steel tubes, household appliances, gas cylinders, dry batteries, X-ray equipment, and steel products.

- As noted in the earlier discussion of key policy issues, India has been particularly energetic since 1993 in bringing anti-dumping cases, 300 of which have been completed. Almost all have resulted in the imposition of specific duties on imports from particular firms and countries on top of normal import duties. The total resulting import tariffs are often prohibitive, and India's activity in India is steadily undermining much of the other efforts-including tariff reduction-to liberalize the trade regime. As can be seen particularly in Pakistan's adoption of the same weapon, India's example is influencing the other South Asian countries to also embark on anti-dumping. Aside from creating important "terms of trade" losses by penalizing reasonable pricing, channeling protection notably to Indian producers of intermediate goods and bolstering the market power of a few, highly concentrated Indian industries, the invocation of anti-dumping claims raises the risk of retaliation against Indian exports in the markets of aggrieved importers.

Despite the persistence of old, reworked and relatively new obstacles to trade liberalization, India has seen the share of imports in GDP increase by more than half since 1988, from around 7 percent in to 11 percent in 2001. As a result, the decline in tariff revenues as a share of GDP has not been precipitous --from about 3.5 percent in 1988 to 1.8 percent in 2001 -- and the sharp rise after 1999 in the contribution from domestic indirect taxes and direct taxes suggests that further substantial tariff reductions in the near term would be fiscally easy to sustain, especially assuming likely increases in imports in relation to GDP.

Moreover, as imports have risen, so have India's exports, backed in many cases by new policies aimed directly at encouraging, even indirectly subsidizing, the sale of Indian manufactures and produce in world markets. Instituting an extremely elaborate export incentive and promotion apparatus, India has the region's most comprehensive and complex set of policies to expand exports. In addition to a range of indirect subsidies, specific schemes support exports of gems and jewelry, electronics hardware and software, Jute, textile products and, since 2001, surplus wheat and rice. At the same time, India restricts exports of fertilizers, some specialty chemicals, and agricultural commodities. It taxes leather exports and gives State Trading Enterprises control over exports of some metal ores, maize, onions and, like all its neighbors except Sri Lanka, petroleum products.

In the judgment of an official, January 2002 Department of Commerce report on India's Export-Import policies, noting India's slowness to embrace export-oriented change:

... the mind-set regarding exports has remained virtually unchanged. Even today, when policy makers address the issue or exports, it is mainly in terms of their contribution to foreign exchange earnings and thus the extent to which they fund our imports. The ... Government must re-orient this attitude and recognize the multifaceted contribution of exports to the economy, in terms of developing links with the high productivity and high quality markets abroad, thus providing a basis for improved efficiency at home. ...

PAKISTAN: If it were not for the long-standing ban on imports from India of products not on a limited positive list of 600 items, Pakistan could be counted a high achiever – at least since 1997/98 – among South Asia's trade liberalizers. Having widely used import licensing and other non-tariff barriers to imports, it began to remove them during the 1980s and continued to the point that by 1998, the proportion of product lines subject to traditional QRs was only 2.7%, slightly lower than the proportion in Sri Lanka in the same year.

Not only did the removal of QRs proceed for most of the period behind declining but still very high tariff barriers, in 1998 some of the industries protected by the remaining QRs and also by government or government controlled import monopolies were very large, including, for example most

of agriculture and the fertilizer industry. But starting in 1997/98, Pakistan embarked on a radical new trade liberalization program which by 2003-subject to some exceptions- had eliminated all the remaining traditional QRs and parastatal import monopolies, while drastically reducing the level and simplifying the structure of import tariffs.

Examples of both extensive and incomplete reform include:

- Its four-rate (5,10, 20 and 25 percent) tariff regime has been radically liberalized in the last five years. Customs duties now constitute the sole explicitly protective import tax. From a very high 1996/97 level (an unweighted average rate 41.7%), administered under a complex and opaque structure including large numbers of rates or "slabs" (14 "normal" ad valorem rates) and characterized by many exemptions and partial exemptions, Pakistan is now operating with a relatively simple structure. Its tariff reduction program brought unweighted average tariffs down from 41.7% to 20.4% in 2001/02 and to approximately 18.2% in 2002/03.
- Like all the other tariff reduction programs in South Asia, Pakistan's was "tops down", with reductions in the top normal tariff rate pushing more and more tariff lines into lower rate categories or "slabs". However, the number of slabs was also reduced independently of the reductions in the top rate, notably from 14 to 6 between 1996/97 and 1997/98 and later on in 2001/02 with the abolition of the zero tariff slab, cutting the number of slabs to from 5 to just 4 at present.
- Despite the steady reduction of the top rates and the removal of the zero-duty slab, tariffs in Pakistan are still quite dispersed, although far less than then they were in 1996/97 and before. In 2001/02 over 40% were either at 5% or 10% and almost 40% at 30. The reduced number of tariff slabs, and the large numbers of tariff rates within HS chapters that are identical, have increased the transparency of the system and should have reduced the transaction costs of the business community and the administrative costs of the Customs administration.
- The "tops down" reduction of tariffs in Pakistan also seems to be reducing the role of tariff exemptions and concessions, for which there is obviously a greater demand when tariffs are high. Most of these exemptions and concessions are for particular users, leading to many situations where the identical product pays different import duties depending on who imports it. The majority of concessions benefit engineering and metal working firms, including firms in the auto industry. A majority are linked to local content (TRIMS) agreements under which the import duty reduction is given in return for commitments to incorporate specified locally produced inputs or to meet domestic local content targets. Others are simply requests from using firms for lower tariffs which are granted if the particular input cannot be supplied by domestic producers.
- The system holds considerable potential to create negotiating opportunities and delays, leading to inefficient economic decisions. Since the local-content arrangements clearly breach the WTO TRIMS agreement, the government decided to phase out all except those in the auto industry, some going in June 2002, others by December 2002, and the remainder to go by June 2003. It has also been announced that the auto industry programs will be abolished by December 2003, even though it is unclear whether this will actually be done.
- Pakistan, however, still employs many technical regulations and regulations based on health and safety, including restrictions on imports of second-hand products justified on health and safety grounds, and in many cases protection of local industries is clearly a dominant motive (e.g. Pakistan's ban on the import of second hand cars).
- Compared to the other South Asian countries, Pakistan has very few "tariff peaks" i.e. tariffs higher than the general maximum of 25%. However, one set of very high tariffs, with rates of 60%, 75%, 125%, and 200%, protects truck, auto and motorcycle assembly and is part of a complex regulatory framework which gives tariff concessions on imported components in return

for local content commitments. Apart from these, high tariffs on alcoholic drinks appear to be for consumption control since there is no officially recognized domestic production.

- A steep and steady decline in tariffs and in the tariff collection rate in Pakistan during the 1990s was accompanied by a correspondingly steep decline in the contribution of tariffs to indirect tax revenue from about 46 percent to only 15 percent in 2001/02 and, as a share of GDP, from around 4 ½ percent in the early 1990s to 1.73 percent in 2001/02. However, revenue from a VAT-style sales tax on imports went up as revenue from tariffs went down, and exceeded tariff revenue from 1999/2000 onwards. The combined contribution of the tariffs and the sales tax on imports to total indirect taxes consequently declined only slightly over the period up to 2000/01.
- The extent to which government revenue continues to rely on taxes on imports is a cause for concern. In 2000/01 tariffs plus sales taxes on imports accounted for 34.4% of total government (central and provincial) tax revenue and 49.1% of total indirect tax revenue, and the sales tax on imports accounted for 57.7% of total sales tax revenue, this share having risen from around 45% in 1990/91. If in fact as this suggests sales tax collection in the domestic economy is less comprehensive and rigorous than on imports, the sales tax would not be operating as intended as a protection-neutral VAT, but to an unknown and probably haphazard extent as another protective import tax.

As an exporter, Pakistan still retains a few restrictions and a range of import-duty neutralization programs and, along with India and Bangladesh, a 25% freight subsidy, transport and marketing subsidies to agricultural exports, and also indirect subsidies through export prohibitions, restrictions and taxes applied to raw materials used as inputs for processed products. Like its neighbors, it has also set in motion a number of official export-promotion efforts and, matching India's example, an initiative to boost exports of gems and jewelry and computer software.

BANGLADESH: Maintaining tariffs that are, along with India's among the world's highest, Bangladesh is also the last South Asian state to retain traditional QRs on imports. Pervasive until the late 1980s, when they covered nearly 56% of items at HS 6-digit level, Bangladesh's protectionist QRs were steadily reduced during two rounds of trade liberalization that also brought sharp reductions in tariffs. The Import Policy Order (IPO) of 1993-95, however, marked the high point of the liberalization process; its successors in 1995-97, 1997-02, and 2003-06, have left in place a system that bans some imports entirely

There are two lists for QRs: the first group consists of items -- agricultural products (chicks, eggs, salt), packaging materials, and textile products -- whose importation is banned and a second category of goods that can be imported subjected to fulfillment of certain conditions. Nearly 40% of all QRs apply to textile products that enjoy the heaviest protection. Although the readymade garment sector imports woven fabrics and grey cloth duty-free under bonded warehouse facilities, the system is cumbersome and susceptible to corruption (through leakage into the protected domestic market). Although some bans/restrictions are ostensibly applied on grounds of health, religion, environment, culture and so on, many of the prohibitions or restrictions cannot be justified on these grounds, and are presumably included for protection purposes (e.g. salt, insecticides for mosquitoes).

Further, Bangladesh has managed to replace the import licensing it abolished early in the 1990s, it still requires various permits, clearances and approvals that amount to licensing by another name. Additionally, the administrative procedures designed to manage QRs function as "non-automatic licensing" that implicitly places import ceilings on certain products. Finally, meeting the requirement that importers register involves a costly layer of bureaucracy with clear potential for obstruction and abuse.

Bangladesh's efforts since 1993 to justify its QRs as trade measures taken for balance-of-payments reasons lose credibility along with the recent, approaching current account surpluses. In any

case, a legitimate invocation of the BOP rationale would require restraining the general level of imports rather than the specific "unimportables" that Bangladesh committed itself to phase out in 1999 before the WTO Committee on BOP.

State enterprises that monopolize the import of petroleum products put another hurdle in the path of trade reform, and relaxing their domination does not necessarily liberalize commerce in the goods they controlled. Sugar, for instance, is no longer a monopolized import; instead it is subject to a total of 70% tariffs and other levies. Moreover, government practices generally discriminate against suppliers from abroad by offering explicit price preference margins or discriminatory tendering, and current export policy explicitly encourages the use of local raw materials, the intent being to establish backward integration, particularly in the textile and RMG sector. (The influence that Bangladesh's state-owned enterprises in such sectors as sugar, jute textiles, oilseeds and oilseed processing, and textile fabrics exercise over economic and fiscal policy extends far beyond their role in keeping trade barriers high. Having come into being in an era when import substitution dominated regional development efforts and a good deal of accepted development theorizing by respected international analysts, these SOEs are political and policy burdens for South Asian reformers in a number of fields.)

Under the heading of tariff reduction and simplification, Bangladesh's reform momentum has also left it with a four-tier tariff structure[3], now the highest average tariff levels in the region, and not just one additional import tax, but two other protective taxes applied to give extra protection to selected local industries. Between them, the three taxes raise the unweighted average protection provided by Customs tariffs by about 50 percent. They also increase the complexity of Customs administration, reduce transparency, and increase opportunities for corruption in Customs clearance.

Another reason for the resistance to further tariff and import tax cuts may be the public finance consequences for Bangladesh, where protective import duty revenues are currently around 25 % of total government revenues and 41% of total indirect tax revenues. Since smuggling (both unofficial and "official" i.e. involving bribery of Customs officials) is generally recognized to be a serious concern for Bangladesh, the revenue losses from tariff reductions are likely to be at least partly offset by the diversion of some of this illegal un or under-recorded trade into legal channels. Even so, 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.

SRI LANKA: Having scrapped most of its QRs in the course of its 1977 reforms and dropped others in the next two decades, Sri Lanka, in 1998, retained only 3.7% of its tariff lines subject to import restrictions explicitly aimed at protecting local industries. The residual QRs, however, carried significant weight. Not only did they apply (in the form of seasonal import licensing) to rice, potatoes, chilies, and onions -- the main import substitution food crops—but also restricted imports of such industrial products as timber, chemicals, some drugs, and motor vehicles. Losing its argument before a WTO panel that the GATT balance of payments clause justified such practices, Sri Lanka did away with QRs in May 1998 except for GATT-sanctioned health and safety and technical standards and regulations and the import monopoly over wheat (which is not grown in Sri Lanka) justified under the GATT state trading provision.

The role of protecting import substitution crops has not disappeared, but shifted to seasonally varying tariffs, and specific duties. Still, its protective tariffs are markedly lower than those in India and Bangladesh. Subject to some qualifications, Sri Lanka is a relatively low tariff country by the general standards of developing countries. Its average total protective tariff was 10.5 percent, and its general protective maximum tariff that year stood at 31 percent. On the export side, Sri Lanka was a regional pioneer entrant in developing a garment industry aimed at foreign customers. Its practices are less

[3] Brought down to four-tier tariff structure under the recently announced FY05 Budget.

advanced, however, in two other major export industries, tea and spices, where export taxes, though few and minor, nonetheless impede efficient development by disallowing imports of tea varieties for blending with local teas, and spices for partial processing and re-export during periods when domestic spices are not available. Both restrictions appear to be responses to lobbying by domestic growers who object to the potential competition and the adjustments that would be required if the imports were allowed.

NEPAL: With a low (2.75 percent) general tax on exports and only its state oil company acting as an official monopoly exporter, Nepal's export regime is like Sri Lanka's in another sense; it restricts imports of machine-spun woolen yarn to protect the hand-spun yarn producers who supply its export carpet industry. That interference, though, prevents the development of woolen carpet exports using imported machine spun yarn. Already, garments using duty-exempt imported fabrics and other textiles as inputs have become Nepal's largest export (about 28% of total exports in 1999/2000). The next largest category is carpet exports, another industry making fairly intensive use of imported fibers and yarns.

Currently negotiating WTO accession and reportedly being asked to bind all or most of its non-agricultural tariffs at relatively low levels, Nepal began trade liberalization in the 1990s. Not yet as liberalized as Sri Lanka's, its policies are still closer to those of its mainland neighbors. For example,

- Tariff slabs number only five, but the highest – 40 percent – is above the top nominal rates anywhere else in the region.
- Except for the monopoly over fertilizer imports by the parastatal Agricultural Inputs Corporation until November 1997, Nepal has made little use of import licensing and other non-tariff measures.
- Instead, the source of Customs duties that account for 3 percent of GDP, various tariffs have been and still are high. Its average of total protective import duties is 16.5 percent, and Average agricultural protective import taxes in Nepal ((16.3%) are a bit above Pakistan's.
- Moreover, beginning in 2002, Nepal imposed a sliding-scale security tax on imports to help finance extra government expenditure resulting from the domestic conflict between the government and the Maoist guerillas. Unlike the National Security Levy in Sri Lanka, which was also imposed to help finance a civil war, the security tax is not imposed on domestic production and therefore increases protection of Nepalese domestic industries.

Significantly in the context of its ability to reduce import levies, Nepal depends heavily on import duties for fiscal revenues. The level of reliance has remained about as high as it was during the 1980s before it began liberalizing trade. Import duties account for 40-45 % of total indirect taxes, 30-35% of total tax revenue, and around a quarter of total government revenue Somewhat surprisingly, the average import duty collection rate in Nepal (which reflects tariff preferences affecting about 40 percent or so of its imports which come from India) is more than double Sri Lanka's. Together with its relatively high import/GDP ratio, this explains the very high shares of tariffs in GDP and government revenue in Nepal.

Performance of 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 textiles -- key sectors in terms of their shares of the workforce and GDP in the region. The findings are valuable in identifying areas of the economy where trade liberalization – some of it already in progress – holds significant promise of stimulating growth that 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

[4] The 133 products and product groups include food ingredients, powdered milk and other milk products, cements, steel tubes, household appliances, gas cylinders, dry batteries, X-ray equipment, and steel products.

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: With all but Nepal having WTO membership and being AoA signatories, the Uruguay Round, by permitting the countries to bind their agricultural tariffs at very high levels, had little or no immediate impact on their agricultural trade policies. Instead, India, Pakistan and Bangladesh have had the latitude to increase applied tariffs up to levels which in many cases amount to *de facto* import bans. Moreover, despite agreeing in principle to "tariffs only" protection of agriculture, except for recognized GATT-legal import controls, some countries have implemented these controls to protect particular primary and food processing industries, even employing some *prima facie* GATT-illegal QRs.

Another major consequence of the AoA was that all the South Asian countries agreed not to pay any export subsidies, apart from transport and marketing subsidies until January 1, 2004, and apart from the use of normal export mechanisms such as duty drawback etc. Since 2001, India's heavily subsidized disposal of large surplus stocks of wheat and rice has made the pledge to scrap export subsidies a major issue. These sales undoubtedly breach 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 with significant export sales relative to world markets, its conduct raises basic questions about the credibility of the AoA agreements and India's own long-term interest in open world agricultural markets.

India's use of such subsidies dates to the April 2001 removal of its QRs and import licensing system, but also responds to the substantial declines since the mid-1990s in world prices of some major agricultural commodities, such as food grains, edible oils and oilseeds, cotton, and rubber. Since, except in Pakistan, real effective exchange rates remained about the same between 1997 and 2002, these world price declines have been more or less fully reflected in real domestic-currency border prices and, not surprisingly, have been important elements behind strong pressures for increased agricultural protection and subsidies which have emerged in South Asia since 1997. 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 open trade policies for their agriculture livestock and food processing sectors.

Noteworthy features of current protection policies for the livestock, agriculture and food processing sectors, apparent from the applied tariffs and non-tariff measures, include:

- In terms of these 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 a few exceptions (notably edible oils in Pakistan), these 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 standards), 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.
- There are some striking differences between 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.

In responding to export opportunities 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. For many years both countries had used QRs 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 the Ministry of Commerce (DGFT) can announce quantitative ceilings "from time to time".

Despite their zero-export subsidy commitments under the AoA, South Asian countries are applying 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. Various specialized facilities and subsidies that are generally available to exporters are being used 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 for a number of primary export.

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 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 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.

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 unbridled competition in a quota-free regime.

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 readymade garments (RMG) in the 1990s, Bangladesh and Nepal suffer from major weaknesses that might stifle future growth of RMG exports. These are: total 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, problems with ports and inland transport, and so on. Post-MFA challenges in gaining greater market access in the expanding market for T&C products will be far greater for these countries than for India or Pakistan, which were endowed with large competitive primary textile sectors and which appeared to have been constrained by the 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 would 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, the countries of South Asia can see very substantial economic opportunities in the MFA phaseout. But for many reasons, with the exception of Sri Lanka, the continuing high protection of all or substantial segments of their domestic markets suggests that they are far from ready to take full advantage of these opportunities. Multiple considerations suggest the gains that could come from reform:

- Not only does high protection take the pressure off industries to improve performance, but protected industries are not likely to compete effectively in post-MFA, low-cost, internationally competitive domestic T&C markets. 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.
- Exports from a high-cost protected domestic industry, moreover, are much more vulnerable to anti-dumping and countervailing duty sanctions in importing countries. They can be penalized for subsidized input prices and 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.
- Reform is also important for the bilateral and multilateral negotiations on world T&C trade that 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.
- In addition to market openness as a remedy against smuggling, open domestic markets would benefit South Asian consumers, since not only are T&C exports important, but domestic sales are very large.

Epilogue

Integration into world markets spreads the rewards of growth across many economic sectors and social groups, but there can be painful dislocations – for globalization in developing and developed countries produces losers as well as winners. Trade liberalization is not a cure-all: it can hurt the vulnerable, often acutely, but it can and does create opportunities that protectionism denies for even the least well-placed. Nevertheless, there is now overwhelming accumulation of evidence across the globe suggesting that, over the long haul, trade openness is a more trustworthy friend of the poor than protectionism. There is hardly any evidence to show that a country has achieved rapid growth without

expansion of trade. Finally, trade reform in developing countries is a necessary, though not a sufficient, condition for an improved growth performance, which requires at least some minimal levels of political and social stability, security, and attention to basic social welfare institutions. It also typically needs to be accompanied by other complementary policies, such as de-regulation, reforms to improve governance and reduce corruption, deregulation, the upgrading of infrastructure services, and an improved overall investment climate.

South Asians need only look at Myanmar to see the human price of isolationist policies that verge on autarky. For contrast, they can look to their own successes, whether building textile and clothing industries in Bangladesh, Nepal and Sri Lanka from scratch (admittedly under the temporary shelter of MFA quotas) or turning India into an exporter of gems and jewelry and high technology software services.

The considerable and commendable progress made in recent years toward opening long-protected markets and redirecting incentives away from import substitution toward export competition signals how much can be done. Much more remains to be done. The recommendations made above do not underestimate the challenges policymakers and publics face. They are meant, though, to help guide an undertaking that gets no easier the longer they are postponed.

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