SOUTH ASIA REGIONAL INTEGRATION AND COOPERATION

ISSUES, OPTIONS AND THE WAY FORWARD

Confederation of Indian Industry

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Executive Summary

The South Asian Association for Regional Cooperation (SAARC) was established on December 8, 1985 at the first Summit in Dhaka (7- 8 December 1985) with adoption of its Charter by the Heads of State or Government of Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka. Afghanistan was inducted as the eighth member of SAARC in April 2007. The prime motive of formation of SAARC is acceleration of the process of economic and social development throughout the region by working together with a spirit of friendship, trust and understanding. The motto of cooperation in the SAARC is build on the base of mutual respect for the principles of sovereign equality, territorial integrity, political independence, non-interference in internal affairs of the Member States and to reap mutual benefit. Regional integration in South Asia can also complement bilateral and multilateral relations among Member States of SAARC.

Over the past two decades, South Asia has sustained an average growth rate of 5.5 per cent per annum. This impressive growth rate is driven mainly by successful implementation of first generation reforms of the early 1990s in the region. The first generation policy reforms mainly involve improvement in macroeconomic indicators including increase in international trade and greater involvement of private sector with decreasing role of governments in different areas. But at the same time, South Asia faced external shocks such as the East Asian crisis and recession in the world economy as also domestic shocks including the Afghan and Iraq wars, oil price hikes, natural calamities, political conflicts and terrorism etc. However, undoubtedly reforms of the 1990s have made South Asia more competitive, stable and adaptable.

The South Asian region is endowed with rich resources, both natural and human. South Asia, particularly India, is enjoying the advantages of a demographic dividend – for example, 53 per cent (554 million) of India's population is under 25 years old. Moreover, South Asia has become the fastest growing region in the export of services in the world with an impressive overall growth in different service sectors like IT, ITES, business

process outsourcing (BPO), finance and banking, soft infrastructure like education and healthcare, and professional services like accountancy, engineering, legal, and architecture. Therefore, a closer analysis of the macroeconomic statistics implies that the region has tremendous possibilities to be a strong regional and economic force in future.

Despite the stable growth trend and very impressive growth in services sector, South Asia has not expanded to the desirable extent. With over one-fifths of the world population, the region has the world's worst per capita income. Its combined gross national income is $3 trillion and the region contributes only about 1 per cent of the world production. The region holds a share of a mere 1.5 per cent of world trade.

In spite of first generation policy reforms, South Asia remains the most protected region in the world. The region is characterized by weak investment climate, weak institutional support, high cost of trading across borders and doing business, poor infrastructure and lack of communication links. So, in an obvious way it remains the least integrated region of the world. Though tariff levels in South Asia have been rationalized, the region continues to have one of the highest tariff levels in the world. Non-tariff barriers and dispersed protection levels are responsible for the low level of integration in South Asia. Similar geographical characteristics of the South Asian countries imply near-identical comparative advantage and affect intra-regional trade.

An important concern of South Asian countries is infrastructure especially trade-related infrastructure systems. The most affected areas are port and power. In South Asia, clearance times for cargo through the ports are among the slowest in the world. Most seaports in the region are suffering from congestion and outmoded infrastructure and therefore rising transaction costs of trade. South Asian firms report severe problems of power shortages, breakages and poor electricity systems.

Against the backdrop of impressive economic growth and successful first generation reforms on the one hand, and poor performance in external sectors like trade, investments and broadly in regionalism on the other, this report discusses the challenges and constraints of regional integration and for sustaining growth for all South Asian

economies. The paper suggests a set of policy choices for South Asian countries aimed at increasing trade, investment and productivity through greater economic cooperation. While the reform agenda appears daunting, the enthusiasm and openness in South Asia today builds the hope that some, if not all, of these challenges can be met and SAARC will grow as a successful regional bloc in a few decades.

The paper also states that regional economic integration can, by exploiting the synergies, expand the economic opportunities available and strengthen growth prospects. The recent experiences with economic integration in the region suggest that these lead to expansion of trade and development in a balanced and sustainable manner. Regional integration can be an effective tool in ensuring that no region/country is left behind and thus promote inclusive growth. Regional cooperation increases welfare by reducing political conflicts and associated social and economic costs within any region. To benefit from greater regional coalition, South Asia definitely needs to focus on trade facilitation unilaterally, regionally and multilaterally. Greater regional integration can boost inflow of FDI and lessen the risk associated with investment.

Another key feature of SAARC is the significant role of India. India is the best performer in the region, enjoying one of the highest rates of GDP growth in the world, and commanding a very respectable position in multilateral discussions. It just has to win the confidence of its neighbors, and not be viewed as a big threat.

CHAPTER 1

INTRODUCTION[1]

[1] This report greatly benefitted from the analysis carried out in the following two World Bank South Asia Region Reports:

- South Asia – Growth and Regional Integration, December 2006, Poverty Reduction and Economic Management Unit, South Asia Region, Report No. 37858-SAS, World Bank
- Trade and Transport Facilitation in South Asia – Systems in Transition, Energy and Infrastructure Operations Unit, South Asia Region, World Bank

The South Asian Association for Regional Cooperation (SAARC), currently comprising the eight South Asian countries of Afghanistan, Bangladesh, Bhutan, India, the Maldives, Nepal, Pakistan and Sri Lanka, formally came into existence in on 8th December,1985 with the adoption of its Charter at the first Summit in Dhaka (7- 8 December 1985). The idea of regional cooperation in South Asia was first raised by Bangladesh at a regional forum in 1980. The prime motive of formation of SAARC is acceleration of the process of economic and social development throughout the region by working together with a spirit of friendship, trust and understanding. The rationale behind the formation of SAARC is backed by successful regional experiences throughout the world and the belief that the countries in the South Asian region would also benefit from it substantially. There are also reasons for optimism since there is commitment at the highest levels in both the government and the private sectors across the region. The motto of cooperation in the SAARC is built on the premise of mutual respect for the principles of sovereign equality, territorial integrity, political independence, non-interference in internal affairs of the Member States and to reap mutual benefit. Regional integration in South Asia can also complement the bilateral and multilateral relations among Member States of SAARC.

Although overall economic cooperation among the SAARC members has not been impressive, various constraints for trade facilitation, inefficient transport logistics, and cross-border structural rigidities are mainly responsible for holding back the success of SAARC as a regional production base and a single market, implying that regionalism will definitely add to its economic dynamism and resilience. While it is necessary to create a favorable environment for trade and investment in South Asia, the key policy barriers to trade and foreign investment still linger. Political harmony on economic policies is crucial to strengthen economic ties in South Asia. Politico-economic considerations are the main driving force behind the emergence of regional blocs. Regional co-operation will strengthen regional as well as national security. Thus, only a win-win trade relationship can build up a perfect stage for SAARC to move forward. The paper indicates the parameters reflecting poor trade integration in South Asia, both intra-regionally and with the rest of the world. The main problem areas are then highlighted

which need to be squarely addressed at the highest political levels so that all constraints to trade are reduced.

Each country of South Asia region is rich in its own heritage and culture and has the unique component of a shared glorious past. Though the vastness, biological and cultural diversity, location and natural surroundings have made this region the most attractive peninsula on earth, its level of economic development, in comparison to other regions, is minimal. With over one-fifth of world population and a combined gross national income of $3 trillion, South Asia only contributes about 1 per cent of world production. This region is home to almost half of the world's poor living on less than $1 a day. Hence, attacking poverty is overwhelmingly important for South Asia. Great efforts towards globalization are needed to step up growth and reduce poverty.

South Asia shares a very small percentage of world trade, less than 2 per cent with less than 1 per cent share of world's exports. On the one hand, this region is endowed with huge natural resources, while on the other, it suffers from social and political unrest, low economic progress, low literacy rate, insufficient health facilities and extreme poverty, which is resulting in increasingly wider gaps between classes of people, i.e. very low percentage elite and rich people, a significant proportion of growing middle class, and a large bottom-of-the-pyramid base. Thus, this region is characterized by unjust distribution of these resources, resulting in deep-rooted disparities, conflict, destitution and systemic marginalization.

Political systems are also uneven – ranging from military regimes, limited democracies and democracies in transition. Even within democracies, democratic cultures and institutions remain weak and their autonomous functioning is questionable. Historical circumstances have led to weak political bonds between member states, despite strong cultural similarities, and united political will towards regional integration needs to be deepened and strengthened. Geographically, India is the central entity, leaving other states with no common borders, except in the case of Pakistan and Afghanistan. Two of the members are island-states, while three are landlocked. Thus, geopolitical

circumstances too have hindered development of robust trade and investment systems within the region.

Despite impressive economic progress during the 1990s, the countries in the region have among the lowest per capita incomes in the world. India is the largest South Asian country in terms of population and land area, and best performer in terms of Gross Domestic Product (GDP) followed by Pakistan and Bangladesh. In 2006, India, being one of the fastest growing economies in the world had growth rate in GDP of 9.2 per cent. Other South Asian countries like Bhutan (7.8 per cent), Sri Lanka (7.4 per cent) and Pakistan (6.9 per cent) have also shown remarkable improvements in economic growth[2]. It is this steady growth that has attracted the world's attention to the South Asia region.

Impressive growth trends in South Asia were driven by first-generation policy reforms, including greater global integration, macroeconomic stabilization, and economic deregulation. The reforms also include reduction of trade restrictions including import tariffs and widening role of private sector as the engine of growth with limited role of governments.

Under the first generation reforms agenda, trade barriers in South Asian region have considerably reduced. This resulted in increase in international trade of the region. Export and import ratios rose in South Asian countries between 1990 and 2004, except the imports/GDP ratio in Pakistan. In India, exports/GDP ratio rose from 7.1 to 19 per cent and imports/GDP ratio from 8.6 to 22.5 per cent. Likewise, in Bangladesh, exports rose from 6.1 per cent of GDP in 1990 to 15.5 per cent in 2004 while imports rose from 13.5 to 20.8 per cent over the same period (World Bank Database). But the increase in overall trade as a share of GDP is not as impressive as in other regions of Asia and the rest of the world. Over the last two decades, exports from South Asia had increased from a little more than 10 per cent of GDP to a little less than 20 per cent, whereas in East Asia, exports rose from about 20 percent to almost 50 percent of GDP.

[2] In 2006, the GDP growth rate of Maldives was 23.5 per cent, after having a negative growth rate (-5.1 per cent) in 2005.

The performance of the services sector is vital and impressive for development in South Asia since it accounts for over 50 percent of GDP in all South Asian countries except Nepal. However, except in Maldives, where the main contributor is tourism, trade in services as a proportion of GDP has not been very high (less than 10 per cent). India has experienced a steady growth in exports of services, mainly attributed by trade in IT and ITES. Pakistan, Sri Lanka and Nepal have also performed well in services trade but not to the same extent as India. Therefore there is an urgency to make services growth more inclusive by identifying services that can generate greater trade, investment and employment. There is a tremendous scope for developing efficient service sectors in the region through an open exchange of ideas and sharing of experiences among the SAARC members.

Despite growth in international trade, the region has failed to increase trade within the countries of the region and thus South Asia is the least integrated region of the world. The statistics state very marginal increase in intra-SAARC trade from the period of formation of SAARC till the date. The overall trade share of the region in world trade is merely around 1.5 per cent. The region is also least integrated in terms of investment flow, movement of people, and sharing of ideas and experiences.

The low level of intra-regional trade has resulted from several factors. A limited export basket, relatively inefficient and uncompetitive production structure in the neighboring countries, high barriers to investment, large scale informal-illegal border trade, continuing Indo-Pak tensions, poor cross-border trading infrastructures and lack of success in SAPTA, are the main reasons for the unimpressive performance. An expansion in intra-regional trade will integrate South Asia faster with the global economy and will increase resistance to external shocks.

Regional integration cam not only increase trade share within the region and with the outer world but also help the region to overcome recent challenges. Regional integration can make several lagging and landlocked region land linked through building roads and infrastructure throughout the region and help progress in those areas. Better economic cooperation can lead to better political relations.

Therefore, to make the formation of SAARC successful, better regional integration is the only way. Currently, the region needs second generation policy reforms in the areas which constrain the natural flow of integration within the region. Policy makers have identified four areas that need special attention in the reform agenda for South Asia.

- High cost of doing business
- Weak institutions
- Weak knowledge economy
- Weak infrastructure.

Among other concerns, corruption and energy shortage are the two biggest problems faced by South Asian firms. Even though some members, particularly India, have been able to exploit the knowledge economy through surge in high-skill manufacturing and services, knowledge indicators including basic literacy remain at dismal standards.

Recognizing this gap, South Asian nations are now addressing second generation reforms to improve competitiveness. This involves improving institutions and governance, allowing greater freedom to market forces, setting in place regulatory structures and encouraging public private partnerships, especially in infrastructure. These recent reforms need to be deepened and sustained for continued high growth.

Another important spotlight of SAARC is India being the centerpiece of SAARC. This is particularly clear with respect to economic co-operation in the region. No meaningful economic integration could take place in South Asia without India's commitment to such a goal and meaningful initiatives to ensure freer trade in the region.

Against this backdrop, this paper looks at several aspects of South Asia’s growth and how regional integration can contribute to its growth. Therefore this chapter provides an introduction to the overall scenario regarding economic status and the necessary future focus for SAARC member countries.

The second chapter describes the current status of South Asian economies, trade patterns, foreign direct investment (FDI), impressive performance of services etc. The third chapter highlights that being the least integrated region of the world, the main and primary focus of SAARC member countries should be greater regional integration to sustain the increasing growth trend and equitably share the benefits of impressive growth. The fourth chapter provides a detailed discussion about the main challenges and constraints to trade and investment in South Asia. The fifth chapter, titled 'The trade and transport facilitation in South Asia', describes the status and importance of trade facilitation and ease of trade in South Asian countries to regional integration. The sixth chapter explains the environment/climate of investment and the extent of facility of doing business and therefore the cost of doing business and investing in South Asian countries. Chapter seven gives details of key reform areas after identifying them and then some recommendations regarding these areas. Chapter eight lists all the recommendations regarding reform areas and other areas where initiatives are needed. The concluding chapter explains the future goals for SAARC.

CHAPTER 2

SOUTH ASIAN ECONOMY AND ITS TRADE PATTERN

South Asia's growth record in recent years has been impressive at an average of close to 6 percent per annum since the 1990s. India's GDP constitutes more than three-quarters of the entire region's output, impacting the regional rate of growth significantly. Statistics show that India grew at 3.2 percent during 1965-81, accelerated to 5.1 percent during 1981-87, and then to 6 percent during 1987-2004. Simultaneously, other South Asian countries including Bangladesh and Pakistan have also experienced remarkable improvements in economic growth.

In 2006, Indian economy grew at 9.2 per cent, while Pakistan's grew by 6.9 per cent and Sri Lanka and Bangladesh expanded at about 7.4 per cent and 6.6 per cent respectively. India reported export growth of 8.6 per cent in fiscal 2006 while Pakistan's export rose 9.9 per cent, Bangladesh's 25.8 per cent, and Sri Lanka's 4.8 per cent.

Over the last two decades, exports in South Asia increased from a little more than 10 per cent of GDP to a little less than 20 percent whereas in East Asia, exports rose from about 20 percent to almost 50 percent of GDP. South Asia, unfortunately, is the world's only region which has failed to tap the potential of economic cooperation, with the continuation of war-like conditions between regions. Intra-SAARC trade, as a percentage of South Asia's world trade, increased from a meager 2.4 per cent ($1.6 billion) in 1990 to 4.6 per cent ($6.5 billion) in 2001 and marginally improved to 4.7 per cent by 2003 and the collective trade share of the region in world trade is only about 1.5 per cent.

Table 2.1: Economic Performance of SAARC Countries: 2006

Countries	GDP (billion current US$)	Total Exports (billion US$)	Total Imports (billion US$)	Foreign direct Investment (million US$)
Afghanistan	8.4	1.71	4.85	2
Bangladesh	61.9	11.75	15.66	625
Bhutan	0.93	0.29	0.55	6
India	911.8	208.42	240.60	16881
Maldives	0.93	0.70	1.05	14
Nepal	8.1	1.23	2.85	5
Pakistan	126.8	20.35	33.23	4273
Sri Lanka	27.0	8.51	11.62	480

Source: World Bank. FDI figures are taken from UNCTAD, World Investment Report, 2006.

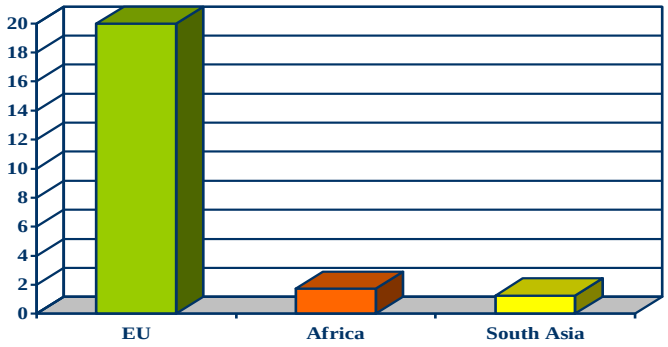
Table 2.2: Growth Performance of SAARC Countries: 2006

Countries	Growth in GDP (per cent)	Growth in exports (per cent)
Afghanistan	5.3	31.4
Bangladesh	6.6	25.8
Bhutan	7.8	*17.6*
India	9.2	8.6
Maldives	23.5	*11.9*
Nepal	1.9	
Pakistan	6.9	9.9
Sri Lanka	7.4	4.8

Note: Figures in italics represent 2004 statistics.
Source: World Bank.

South Asia attracts a minimal share of FDI at just 1.71 per cent of world FDI inflow (2006). This region has fallen behind in the competition for FDI. The inflow of FDI into the South Asian region was just US$ 22.3 billion where the same was around seventeen times higher for all developing economies in the year 2006, and China alone attracted $69 billion in that year.

Figure 2.1: Global Gross FDI as a Percent of GDP, 2006



Source: World Bank, 2007.

In the South Asia region, the export basket comprises mainly natural resources and labor-intensive products, especially textiles, garments, leather goods, seafood, and agricultural products. India, exceptionally, has a more diversified and competitive export basket including technology-intensive products than the rest of the region. Its export basket primarily includes durable consumer goods, intermediate materials, certain machinery and software. The export growth in the region is mainly due to relative quantity increase through a reduction in relative costs rather than relative quality increase. Therefore South Asian exports often fail to meet international standards of quality.

Table 2.3: Less Diversified Export Basket: South Asia

Countries	Export Basket
India	12 categories account 95 per cent of exports (no category accounting for more than 22 per cent)
Bangladesh	< 5 categories account for 95 per cent of exports Textile adds > 85 per cent of exports
Maldives	< 5 categories account for 95 per cent of exports
Pakistan and Sri Lanka	< 5 categories account for around 80 percent of exports

Source: Prepared by author with the support of World Bank Database.

Under the first generation reforms agenda, trade barriers in South Asian region have considerably reduced and therefore resulted in increase in international trade. Export and import ratios rose in the South Asian countries between 1990 and 2004, except the imports/GDP ratio in Pakistan. In India, exports/GDP ratio rose from 7.1 to 19 percent and imports/GDP ratio from 8.6 to 22.5 percent. Likewise, in Bangladesh, exports rose from 6.1 percent of the GDP in 1990 to 15.5 percent in 2004 while imports rose from 13.7 to 20.8 percent over the same period (World Bank Database).

Though rationalized, the tariff level in South Asian region is one of the highest among the regions of the world. Tariffs have reduced from 70 percent to about 35 percent in the 1996-98 and then up to 28 percent in 2005. But the rest of the world has liberalized even faster.

Table 2.4: Simple Average Tariff Rates in South Asia

	India			Pakistan		Bangladesh		Sri Lanka		Nepal	
	1998-99	2002-03	2004-05	1998-99	2002-03	1998-99	2002-03	1998-99	2002-03	1998-99	2002-03
All Tariff lines											
Customs duties (CD)	39.6	29	22.2	21.3	17.3	20	15.7	17.6	9.6	14	13.7
Other general protective taxes		6	0		0		3.3		2.9		2.5
Other Selective Protective taxes		0	0		0		5.8		0		0
Total		35	22.2		17.3		24.8		12.5		16.2
General Maximum CD	45	30	30	35	25	40	30	35	25	80	25
Other general protective taxes		6	0		0		4		6		3
General Maximum: CD + other		36	30		25		34		31		28
Non-agricultural tariffs											
Customs duties (CD)		27.4	19.7		16.9		14.3		7.6		13.8
Other general protective taxes		5.9	0		0		3.3		2.5		2.8
Other selective import taxes		0	0		0		3.5		0		0
Total		33.3	19.7		16.9		21.2		10		16.6
General Maximum: CD + other		36	20		25		34		31		28
Agricultural tariffs											
Customs duties (CD)		40.6	40.1		19.6		22		21.1		13.5
Other general protective taxes		6.5	0		0		3.3		5.2		2.8
Other selective import taxes		0	0		0		3.5		0		0
Total		47.1	40.1		19.6		28.9		26.3		16.3
General Maximum CD		100	100		25		30		25		25
Other general protective taxes		8.6	0		0		4		6		3
General Maximum: CD + other		108.6	100		25		34		31		28

Source: World Bank.

Table 2.5: Tariff Pattern in South Asian Countries

Countries	**Tariff binding coverage (per cent)**	**MFN tariffs Applied 2006 (simple average of advalorem duties)**	**MFN duty free imports (per cent, 2004)**	
			In Agricultural goods	In Non-Agricultural goods
Afghanistan		5.7		
Bangladesh	15.8	15.2		
Bhutan		22.1		
India	73.8	19.2	0.4	7.7
Maldives	97.1	20.2	9.6	0.3
Nepal	99.4	13.9		
Pakistan	98.7	14.3		
Sri Lanka	37.8	11.2	0.7	43.7

Source: World Trade Organisation.

The performance of services sector in South Asia is remarkable and export of services in the region is growing rapidly, led by India. In India, Bangladesh, Sri Lanka and Pakistan, the services sector holds more than 50 per cent of GDP share and therefore has a strong influence in the growth curve of South Asia. Services contribute more than 25 per cent of total export of South Asia. India has become the global leader in IT, ITES and business

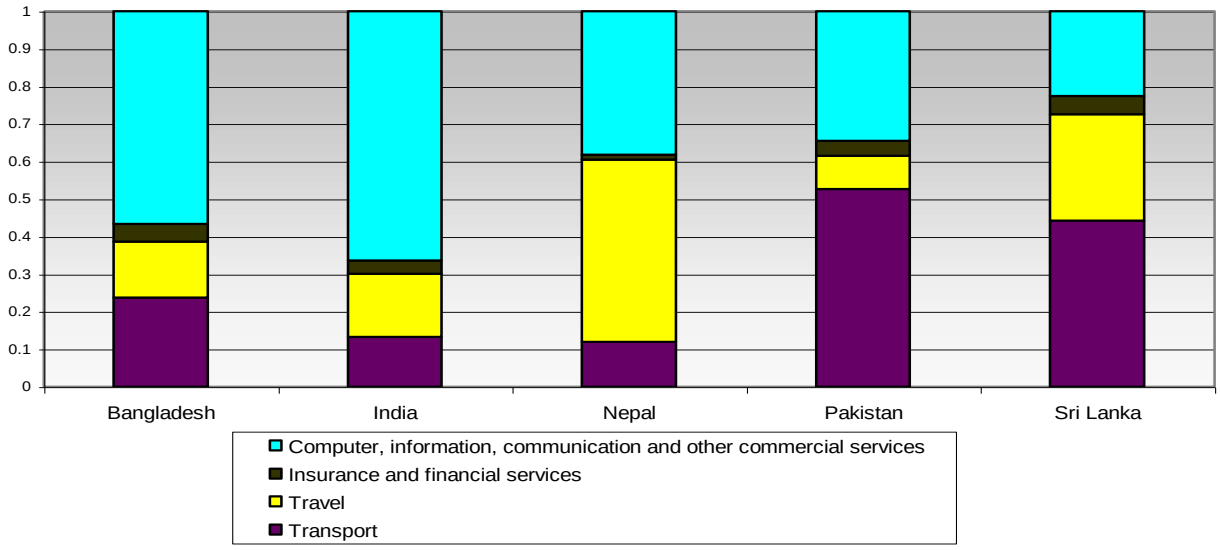
process outsourcing (BPO) services. Other services like financial services, tourism, engineering, construction, shipping, transport, hotel and restaurant and soft infrastructure services like education and healthcare have also developed considerably faster. India has emerged as the tenth largest services exporter (US $73 billion in 2006). Not only India, but services sectors in Pakistan, Sri Lanka and Bangladesh have also grown rapidly.

Table 2.6: Services Exports ($ millions) 1990 to 2005 – SAARC countries

Countries	Commercial Services Exports ($ billions)	
	1990	2005
Bangladesh	0.30	0.47
India	4.61	56.10
Nepal	0.17	0.27
Pakistan	1.22	2.04
Sri Lanka	0.43	1.52

Source: World Development Indicators 2007, World Bank

Figure 2.2: Sector-wise Services Exports - SAARC countries (per cent of commercial services)



Source: World Development Indicators 2007, World Bank.

While the governments in South Asia have moved from inward to outward looking economic policies, the importance of international trade in South Asia, as a proportion of GDP, is well below the world average and is indeed the lowest for any region, other than NAFTA. Exports from South Asia account for only 13 percent of GDP (2005) compared

with the global average of 23 percent. However, the importance of international trade has been growing rapidly, but from a very low base. During the 30 years, 1975 – 2005, exports as a percent of global GDP have increased from 15 to 23 percent. In South Asia, the importance of exports has more than doubled, from 5 percent of GDP to 13 percent. In comparison, however, exports in East Asia have risen almost fourfold in importance, from 10 to 39 percent. In absolute terms, South Asia still has a very small role in global trade, about 1.2 percent of world exports and 1.7 percent of imports, but trade has been growing very rapidly in recent years, over 25 percent annual growth for exports and over 30 percent for imports.

Table 2.7: Direction of Trade in South Asia (Percent)

Countries	USA		EU		Japan		ASEAN		South Asia	
	1990	2002	1990	2002	1990	2002	1990	2002	1990	2002
Export										
India	15	21	21	22	9	4	3	4	3	5
Pakistan	12	25	36	27	8	1	3	2	4	2
Bangladesh	32	35	32	50	4	2	1	0	2	2
Sri Lanka	26	38	26	30	5	3	1	1	4	5
Import										
India	11	7	22	20	8	3	3	5	0	1
Pakistan	13	6	24	17	12	6	5	9	2	2
Bangladesh	6	4	16	11	9	7	7	7	9	20
Sri Lanka	8	4	16	15	12	6	9	8	7	15

Source: COMTRADE via Wits.

International trade in South Asia is directed very largely outside the region, and the region is still relatively protected. The main export partners of the region are North America and EU whereas principal imports come from East and Southeast Asia. Intra-regional trade is less than 5 percent of the region's overall international trade. In terms of imports from within the region, South Asia has the lowest intra-regional trade in the world, less than half the level (3.1 percent) of the next lowest trading region (Middle East and North Africa with 6.6 percent). The economic dominance of India within South Asia has obvious implications but a broadly comparable situation exists in East Asia, with China, and intra-regional trade accounts for 18 percent of the region's imports, magnitudes higher than in South Asia.

CHAPTER 3

REGIONAL INTEGRATION IS THE KEY STEP

As noted in the previous chapter, South Asia has the lowest level of intra-regional trade of any region. Though, over the past two decades, exports from South Asia have doubled but its share in total exports of developing countries has declined, in part, due to relatively slow export growth. This reflects South Asia's limited trade integration with the rest of the world as well. This chapter outlines the dimensions of intra-regional trade, the benefits from such trade to the region, and the issues that need to be considered for promoting trade. Continuing growth in almost all South Asian countries and their rapidly growing export capacities should make the prospect of expanding intra-regional trade feasible and potentially attractive to entrepreneurs, assuming that the political and regulatory barriers to economic interaction are removed or, at least, relaxed. There is clearly a great scope for expansion before the SAARC region reaches the same levels of intra-regional trade as the rest of the world. Table 3.1 shows the extent of intra-regional trade within the world's major geographic regions in 2005. There are wide differences among the nine major regions with regard to intra-regional trade, except that MNA exports to its own region are even lower. The share of intra-regional imports to total imports for EAP is around six times higher than in the SAARC region.

Table 3.1 World Intra-Regional Trade Flows: 2005[3]

	Exports to Own Region		Imports from Own Region	
Region	US$ million	per cent total exports	US$ million	per cent total imports
SAARC	**5,897**	**4.7**	**5,621**	**3.1**
EAP	114,137	9.6	194,475	18.4
ECA	212,520	21.1	215,406	22.9
MNA	14,592	2.2	28,113	6.6
SSA	12,797	6.8	11,631	6.8
LAC	72,531	20.8	71,940	25.2
EAPH	332,032	19.1	267,605	16.5
EEC15	2,140,849	58.2	2,011,361	54.7
NAFTA	870,999	59.0	775,773	34.0

Note:EAP: medium and lower income East Asia and Pacific Countries, with China as its largest member
ECA: Europe (other than the EEC15), and Central Asia
MNA: Middle East and North Africa
SSA: all of Sub Saharan Africa
LAC: Latin America, except Mexico, and the Caribbean
EAPH: high income East Asia and Pacific countries, with Japan as its largest trading member
EEC15: France, Germany, the United Kingdom, etc
NAFTA: the United States, Canada and Mexico
Source: COMTRADE

[3] COMTRADE data for the MNA and SSA regions were still lacking for a number of reporting countries; the partial data may understate the share of intra-regional trade in total regional trade

What is particularly striking in the SAARC region is the abnormally low level of trade between the largest countries, though some trades may be substantially under-reported as a result of (a) cross-border informal trade, outside the customs' regime, and (b) trade routed and re-labeled through third countries.

Table 3.2 SAARC Region: Intra-SAARC Export Trade 2005 (US$ billion)

	Destination Country					
Origin	Bangladesh	India	Maldives	Nepal	Pakistan	Sri Lanka
Bangladesh	-	2.3	0	0.3	1.5	0.2
India	1.0	-	0.4	39.2	1.2	6.8
Maldives	0	0.1	-	0	0	1.1
Nepal	0.1	1.0	0	-	0	0
Pakistan	0.6	0.6	0	0.5	-	0.7
Sri Lanka	0.2	1.9	12.3	0	1.0	-
Total	1.8	5.8	12.7	40.0	3.7	8.8

Source: IMF, Direction of Trade Statistics, Yearbook 2005.

Table 3.3 SAARC Region: Intra-SAARC Import Trade 2005 (US$ billion)

	Destination Country					
Origin	Bangladesh	India	Maldives	Nepal	Pakistan	Sri Lanka
Bangladesh	-	0.1	0.0	0.3	0.3	0.1
India	15.5	-	10.2	42.0	2.5	18.1
Maldives	0	0	-	0	0	0.3
Nepal	0	0.3	0	-	0	0
Pakistan	1.1	0.1	0.3	0.2	-	1.4
Sri Lanka	0.1	0.3	10.6	0	0.3	-
Total	16.7	0.8	21.1	42.4	3.1	25.9

Source: IMF, Direction of Trade Statistics, Yearbook 2005

India dominates trade within the region and has major trade surpluses with all the other countries, most remarkably with Bangladesh. Though intra-SAARC trade has recorded some growth trend, most of its benefits accrued to India because of its large product basket that confers it the pride of being accountable for around 80 per cent of SAARC gross domestic product.

Trade within the SAARC region has increased at rather faster rates than total trade, but generally from very small initial levels. For example, India's exports to SAARC more than doubled between 2000 and 2004, reaching over $3 billion; Bangladesh's imports from SAARC almost tripled between 2000 and 2004, reaching $1.7 billion. As a consequence, the proportion of intra-regional trade in total trade has increased significantly, especially for the smaller countries in SAARC, Table 3.4.

Table 3.4 SAARC Region: Relative Importance of Intra-Regional Trade (Intra-regional trade as percent of total trade)

	1990	1995	2000	2005
Afghanistan	12.2	15.4	22.1	35.1
Bangladesh	6.7	10.2	5.4	9.1
India	1.3	2.3	1.8	1.9
Nepal	26.2	30.5	40.0	46.5
Pakistan	1.9	1.8	3.0	5.7

Source: COMTRADE.

South Asia's intra-regional trade as a percentage of its total trade has remained merely around 2 per cent since 1980 whereas; the share of the same in East Asia (excluding Japan) is 15 per cent. Policy reforms to increase the intra-regional trade further deserve urgent attention in South Asia.

Benefits from Regional Cooperation

Benefits of regional cooperation can be reaped in many forms of improvement throughout the region. Regional integration accumulates foreign direct investments as a result of enlarged markets and economies of scale. It also promotes flow of information and technology and knowledge spillovers, and deeper integration through regulatory cooperation and harmonization. But the region will only be benefitted from regional integration if external protection is low, otherwise trade diversion dominates trade creation.

Regional integration also promotes inclusive growth of all sectors and all countries within the region through agglomeration benefits. It opens up opportunities to several lagging border and landlocked regions by providing communication links and sharing experiences and support from developed countries of the region.

While each of the important intra-regional trading links has particular characteristics and issues, there are some common features, which need to be addressed if intra-SAARC trade is to grow toward the levels achieved in other regions:

- Allowing cross-border movement of road transport
- Improving the capacity of regional rail links

- Upgrading the levels of customs/trade facilitation reform to those at the gateway ports
- Allowing container movements and customs clearance away from the border

Achieving these objectives would provide the trade-transport facilitation basis for substantially increased trade. The extent to which trade would then develop would also depend upon changes in the trade regimes, as in the case of India - Pakistan, or attitudes toward trade, as with Bangladesh - India.

Regional cooperation has a crucial role addressing the intense problem of energy shortages in the region. Dispersed endowments of energy resources and very low volume of energy trade within the region are the main causes behind acute energy shortages in South Asia. Bangladesh has natural gas reserves, but gas trade is very low due to inadequate infrastructure and political misconceptions. Pakistan and Afghanistan can become transit states for the rest of South Asia by providing the best routes for access to Central Asia's energy (World Bank, 2006). Nepal and Bhutan as well as India's north-east have high potential for joint development of hydropower. A regional energy grid can effectively match deficient and surplus energy states, thereby additionally aiding least developed countries boost incomes.

Regional cooperation can be also instrumental in overcoming problems related to geographical and infrastructural isolation which affect Afghanistan, Bhutan and Nepal as well as parts of other countries such as northeastern India, northwestern Pakistan and northern Bangladesh. Such isolation typically causes high degrees of income inequalities between nations and between regions, and can pose socio-economic consequences. Concerted national and regional efforts at structuring holistic regional transport, communication and infrastructure links with high connectivity can help provide access to markets and resources.

Regional cooperation in services can also facilitate integration, especially as the potential for diversion of benefits is low. There is huge potential in tourism for example, including social, religious, and cultural tourism to take advantage of common historical links.

Health and education could also potentially benefit from increased cooperation, through common facilities, specialized centers, or remote service delivery. Language can be a great facilitator in these sectors as well as in business and professional service delivery.

Greater regional integration can boost inflow of FDI. Regional integration lessens the risks associated with investment. Integration by increasing the size of the market will generate necessary scale to attract investments and therefore export, productivity, and technology.

Regional political conflicts, primarily between India and Pakistan are another concern in the way of regional integration in South Asia. Regional and bilateral trade agreements can promote the agenda of regional cooperation within South Asia. Recent initiatives are South Asia Free Trade Area (SAFTA), Bangladesh-India-Myanmar-Sri Lanka-Thailand Economic Cooperation (BIMSTEC) and Comprehensive Economic Partnership Agreement (CEPA) between India and Sri Lanka. SAFTA can potentially help reduce the conflicts, and promote better political ties among neighbors, especially India and Pakistan.

One critical concern in the South Asian region is a high proportion of informal trade between countries that have substantial trade barriers. To circumvent the official trade barriers or overcome absence of formal trade routes and customs facilitation, traders tend to use innovative means to exchange goods. Examples are India-Pakistan trade that goes through Dubai, border trade between Indian and Bangladeshi communities, etc. There is much to gain from formalizing such trade, as is seen in the goodwill generated from border trade between India and China from Sikkim.

India needs to take the lead in regional cooperation due to its prominent geographical, economic and demographical weight in the region. It needs to address the fears of neighbors arising from its large economy and trading capacity. Providing access to South Asian nations to its large markets in a less restrictive manner as well as building better infrastructure on its side of the border could help alleviate some of the historical mistrust.

At the same time, other nations in South Asia need to appreciate the advantages accruing to them from greater economic integration with India, and move towards regional trade.

According to the World Bank, it is estimated that if countries in South Asia upgrade infrastructure and trade facilities - ports, customs, regulations, and trade services - halfway to East Asia's average, South Asia's intra-regional trade can rise by $2.6 billion. This is approximately 60 per cent of the total intra-regional trade in South Asia. If South Asia and the rest of the world raised levels of trade facilitation halfway to East Asian average, gains to the region are estimated to be a whopping $36 billion.

There is definitely an urgent need to focus on trade facilitation, unilaterally, regionally, and multilaterally. The July 2004 agreement of Doha round is a welcome step, and hopefully a well-designed multilateral framework of trade facilitation would be in place, with adequate provisions for technical assistance and capacity building. In this context, SAFTA and BIMSTEC may, in future, lead the way to a regional integration of trade facilitation. But as of now, discussions on trade facilitation have not gone beyond the early design stage.

Key Issues in Intra-Regional Trade

Infrastructure: Most intra-regional trade is not along the main trade corridors and the quality of South Asia's road infrastructure, and its service standards, off the main corridors is poor. There are important differences in the standards of regional railways, in terms of both track and rolling stock, which limit seamless rail services. Where there are big imbalances in the direction of trade, the country receiving the larger flow of imports may feel less incentive to improve the quality of the infrastructure, given the negative attitude to imports.

Transport services: Much of the region's intra-regional trade is carried by road transport and generally the trucks of one country are not allowed to collect/deliver consignments in neighboring countries. Consequently, at the border, cargo has to be unloaded from the trucks of the exporting country and reloaded onto the trucks of the importing country.

Until very recently, there were few, if any, direct scheduled shipping services between the South Asian countries. Containers would thus have to be routed through a hub port, adding time and cost to delivery. For many important trade flows, such as from the west coast of India to Bangladesh, this remains the case and containers have to be routed through Colombo, Singapore, or Malaysian ports.

Documentation: All formal trade requires documentation and throughout South Asia, the governments are in the process of simplifying customs documentation and streamlining procedures. These efforts, in the coastal countries, have concentrated on their main gateways to the world – the major sea and airports. The benefits of such reforms have not yet spread fully to their customs posts handling the more minor trade flows, i.e. the land customs posts handling intra-regional trade. The lack or inadequate quality of the necessary communications and power infrastructure at these customs points would also severely limit the effectiveness of the reforms. Computerized customs clearance requires working computer systems which, in turn, require reliable power supplies. Consequently, the manual systems often continue at the land borders while the computerized systems operate at the major gateways.

Security: The cross border movement of goods, people and vehicles generates potential security concerns to the receiving country. Security is an issue at all borders but, with the tensions in South Asia and high perceived security threats, tight and often multiple security procedures add to the time and cost of cross-border movements.

Corruption: Highly demanding documentation and security procedures provide a conducive environment for corruption as well as encouraging informal trade across the border. Traders are prepared to pay for expedited border clearance. The environment for corruption is further enhanced by the remoteness and poor communications available at many of the land border crossings. Threats to detain cargo until higher management is consulted have particular significance when the higher management may be miles or days away from the customs post.

The abovementioned issues are the main areas that need to be addressed to boost lagging intra-regional trade in South Asia.

Reductions in the level of tariffs through the implementation of SAFTA thus may not substantially increase formal trade unless other constraints are also addressed. **Such constraints may include**:

- **Trade facilitation and transport logistics**: Continued weakness is noticed in port and transport infrastructure, regulatory environments, and service-sector infrastructure. Additional delays are due to congestion in road and transit facilities, inefficiency of customs, lack of harmonization of standards, piecemeal reliance on information technology, and lack of implementation of risk management system in customs.
- **Heavy domestic indirect taxes imposed at border crossing points**, such as the "additional" duties levied in India, sales and income withholding taxes in Pakistan, or VAT and advanced income tax in Bangladesh;
- **High transaction costs at customs posts**, in terms of documentation costs, informal payments and long delays all of which may increase if there are strict rules of origin attached to SAFTA trade. Long distances and high transport costs to/from the nearest customs post significantly raise costs for small local traders.
- **Restrictions on Trade:** A number of restrictions reduce, complicate or shift formal trade into informal channels. For example, Bangladeshi yarn and textiles are not allowed to be imported across the land border with India and have to be shipped to Chittagong which increases the cost and time of import. Pakistan's positive list approach to trade with India results in a significant level of misreported trade: exports from India are routed to Dubai where the goods are relabeled and then shipped to Pakistan under a different certificate of origin.
- **Constraints to Cross-Border Rail Transport**: Rail transport often offers easier customs clearance procedures than road transport partly due to the lower unit value of much of the rail cargo and the low import duties attached to such commodities and also due to the public ownership of the railways. These advantages are most manifest with respect to transit traffic for which bonds and

other restrictions are often not required if the goods are moved by rail. Given the inadequacies of much of South Asia's highway infrastructure, rail should offer potential for intra-regional trade, especially over longer distances. Unfortunately, the realization of that potential in South Asia is constrained by the deficiencies in the asset base of some of the regional railways, as well as the freight priorities of Indian Railways.

- **Constraints to Cross-Border Truck Transport**: Truck transport dominates intra-regional trade throughout most of South Asia, India – Pakistan being the exception. However, with few exceptions, trucks are not allowed to cross the borders to deliver cargo to its final destination. Rather, the goods have to be transhipped from one truck to another, either at the border itself or at transhipment centre a little way from the border. The exceptions to this ban on cross- border movement are: Pakistan trucks are allowed to cross into Afghanistan on the northern Torkham route and transport cargo direct to Kabul. On the southern Spin Boldak route, all cargo has to be off-loaded from the trucks of one country and reloaded onto the trucks of the other country, in no-man's land between the border posts. Indian trucks are allowed into Nepal for 72 hours to deliver cargo. Even where transhipment is more organized, the economic costs are substantial due to such restrictions.

Streamlining Intra-Regional Trade

Considering the key issues and constraints in the way of intra-SAARC trade, some measures are needed to streamline intra-regional trade in SAARC. Key among these would be the following:

- Cross-Border Trucking
- Regional Rail Links and Services
- Upgrading Customs and Trade Facilitation
- Regional Trade Corridors

These are addressed in detail in Chapter 5.

The South Asian policymakers and leaders have started realizing that the success of the SAARC lies in economic integration and cooperation in specific areas. With greater cooperation in terms of trade, foreign direct investment, social sectors, WTO issues,

tourism, information technology and finance, the SAARC can assure a bright future. Regional economic integration with its high potential is definitely one of the key steps for promoting sustainable and equitable economic development in the South Asia region.

CHAPTER 4

MAIN CHALLENGES AND CONSTRAINTS IN TRADE AND REGIONAL INTEGRATION IN SOUTH ASIA

SAARC region has potential to be a strong economic force, but high level protection in the trade front and investment climate inhibit its growth prospects. South Asia is the most protected region of the world. Though tariff levels in South Asia are rationalized, still the region has one of the highest tariff levels in the world. Non-tariff barriers and dispersed protection levels are responsible for the low level of integration in South Asia. Acute behind-the-border constraints, restricted private activity in infrastructure, weak governance, weak institutional support, inefficient financial sector, and poor trade logistics impede productivity growth and hurt export competitiveness in all South Asian countries and above all hinder this region from benefit by exploiting all the potentialities at fuller extent.

Tariff structure

Tariffs in South Asian countries have been continuously rationalized after 1990, and by 2006, the tariff rates had reduced substantially. However, these are still higher than any other regions of the world.

Table 4.1: South Asia: Trade Tariffs

Year	Bangladesh	Bhutan	India	Pakistan	Nepal
	Average applied Tariff Rates (per cent)				
1990	94.0	n.a.	81.8	64.8	n.a.
1995	26.0	21.0	41.0	50.1	11.0
2000	21.2	15.4	32.7	23.6	14.2
2005	16.8	22.2	16.0	14.3	14.7

Source: Trade and Transport Facilitation in South Asia: Systems in Transition, World Bank.

Table 4.2: Tariff Rates in South Asia (All Products) – 2006

Country			Afghanistan	Bangladesh	Bhutan	India	Maldives	Nepal	Pakistan	Sri Lanka
Year of MFN Applied Tariff			2006	2006	2005	2005	2006	2005	2006	2006
Binding Coverage (in per cent)				15.8		73.8	97.1	99.4	98.7	37.8
Simple Average	Bound			163.6		49.2	36.9	26.0	59.9	30.3
	MFN Applied		5.7	15.2	22.1	19.2	20.2	13.9	14.3	11.2
Duty Free	Bound	Share of HS 6 Digit Subheadings in per cent		0		2.8	0	2.7	0	0.2
	MFN Applied		0.5	7.4	3.5	2.4	0.1	0.9	0	12.4
Non Ad Valorem Duties	Bound			0		5.3	0	0	0	0.6
	MFN Applied		0.8	0.1	0	5.3	0.1	0.4	0.7	1.2
Duties > 15 per cent	Bound			15.1		70.4	97.1	88.2	95.0	24.8
	MFN Applied		3.2	39.9	63.4	21.6	59.5	16.6	40.0	20.9
Duties >3* AVG	Bound			0.0		5.0	2.5	0.5	0.0	0.0
	MFN Applied		0.3	0.0	0.6	2.5	0.8	0.8	0.9	0.6
Concession not yet implemented in 2006				0.0		0.0	0.0	2.9	0.0	0.0
Maximum Duty	Bound			200		300	300	200	200	251
	MFN Applied		25	25	100	268	200	184	119	250
Number of distinct duty rates	Bound			16		356	2	13	15	53
	MFN Applied		53	14	7	747	18	43	66	98
Coefficient of Variation	Bound			43		83	116	49	38	65
	MFN Applied		61	57	62	91	62	83	77	114
Number of MFN Applied Tariff Lines			5376	6637	5254	11693	8995	5347	6336	6411

Source: World Tariff Profiles in 2006, World Trade Organisation.

But even while tariff rates have come down, other impediments are imposed or increased. For example, India has various additional duties and very high specific duties for the agriculture sector though already made further reduction in maximum band to 20 per cent in 2004. In the SAARC region, the non-tariff barriers (NTBs) are still high and involve specific quantitative restrictions, tariff rate quotas, import licensing, regulation on technical standards and SPS. In the SAARC region, Sri Lanka has the lowest and Bangladesh has the highest tariff levels. Pakistan continues with its tariff reduction. Nepal has generally low tariffs but a few high industrial tariffs.

Table 4.3: Description of trade regimes related to agricultural commodities in SAARC

Country	Description
Bangladesh	• Simple Average tariff rates (per cent): 32.1 (Agriculture), 25.4 (Non-Agricultural) • Trade related restrictions were limited mainly to three categories: agricultural products (Chicks, eggs, salt), packaging materials, and textile products • Tariff protection is augmented by other border levies and, in some instances, the discriminatory application of internal taxes.
India	• Simple Average tariff rates (per cent): 40.1 (Agriculture), 19.7 (Non-Agricultural) • India's tariff regime seems to be more liberal in 1990s, but is quite restrictive compared to the other South Asian countries in relation to agriculture • State trading monopolies are being maintained over major food grains (rice, wheat, coarse grain except maize and barley) which is equal to 40 per cent of agricultural GDP • TRQs have been imposed under different bilateral trade agreements for importation of tea, vanaspati and pepper (ILFTA), milk, maize, crude sunflower and safflower oils and refined rape and mustard oils (Indo-Nepal trade agreement) • India maintains a list of about 300 sensitive items, including many agricultural products such as milk products, fruits and nuts, coffee, tea, spices, cereals, oilseeds and edible oils, alcoholic products and silk, imports of which are monitored. • Technical standards and health & safety regulations are used for food ingredients, powdered milk and other milk products in India • An SPS certificate is required on the imports of nearly all livestock, agricultural and food products in India. • India has designated ports and inland custom points at which imports can be cleared (under ILFTA) • Restrictions on imports of domestically produced intermediate inputs to India • Indian agricultural producers receive subsidies on fertilizer, power, irrigation, credit and certified seeds
Nepal	• Simple average tariff rates (per cent): 16.3 (Agriculture), 16.6 (Non-Agricultural) • Nepal maintains liberal trade policies and the tariffs are generally low while agricultural trade is more liberal with low tariffs • Nepal's trade policies are indirectly influenced by India's trade policies so that it is protected indirectly from trade policies of India.
Pakistan	• Simple average tariff rates (per cent): 18.1 (Agriculture), 16.6 (Non-Agricultural) • Pakistan embarked on a radical new trade liberalization programme eliminating all remaining QRs and parastatal import monopolies since 1997/98 • There are strong protectionist elements in agricultural policies in terms of the use of technical regulations and regulations based on health and safety • Specific duties on edible oil and margarine • Long standing ban on imports from India • In Pakistan, domestic support for agriculture has been largely aimed at fostering price support/stabilization, food security and raising productivity/competitiveness of the agricultural sector
Sri Lanka	• Simple average tariff rates (per cent): 28.1 (Agriculture), 10.7 (Non-Agricultural) • A marked reduction of Sri Lanka's tariff rates was observed after 1990 for intermediate and capital goods and after 1996 for agricultural goods • Specific duties on rice, chili, potatoes and onion • State trade monopolies on importation of wheat • Sri Lanka's agricultural producers are receiving domestic support in terms of a fertilizer subsidy, irrigation and replanting (for tree crops)

Source: Various sources including World Bank (2004), WTO Trade Policy Reviews, Panagariya (1999), etc.

Under SAFTA, member countries propose to cut the customs tariffs to levels between zero and five per cent over the next seven to twelve years. While the relatively developed

countries like India and Pakistan are required to cut their tariff to these levels by 2013 and Sri Lanka by 2014, the least developed countries (LDCs) are required to cut these tariffs by 2016 years in a phased manner (Rajesh Mehta, 2006).

Table 4.4: Time Schedule of Tariff Concession given by Different Countries of SAFTA

Countries Giving Concession	Countries Getting Concession	MFN Tariff (T) Rage (per cent)	Maximum Level of Tariff (per cent) in Different Years					
		Base Year – July 1, 2006	2007	2008	2009	2013	2014	2016
India Pakistan	LDCs	0 - (any level)			0 - 5			
	Non-LDCs	>20		20[a]		0 – 5[b]		
		<20	0.9*T	0.9*0.9*T				
Sri Lanka	LDCs	0 - (any level)			0 - 5			
	Non-LDCs	>20		20[a]			0 – 5[c]	
		<20	0.9*T	0.9*0.9*T				
Bangladesh, Bhutan, Maldives, Nepal	ALL	>30		30				0 – 5[d]
		<30	0.95*T	0.95*0.95*T				

Note: a = Encouraged to reduce in equal annual instalment during first two years.
b = Encouraged to reduce in equal annual instalment from 3rd to 7th year (5 years), but not less than 15 percent per annum.
c = Encouraged to reduce in equal annual instalment from 3rd to 8th year (6 years period), but not less than 15 per cent per annum.
d = Encouraged to reduce in equal annual instalment from 3rd to 10th year (8 years) but not less than 10 per cent per annum.
Source: India's Regional Trading Arrangements by Rajesh Mehta and S. Narayanan, RIS-DP # 114, Research and Information System for Developing Countries.

Table 4.5: SAFTA: Number of Tariff Lines* (6-digit HS level) where no Tariff Concession will be given by Different Countries

Importing Country	Countries which will not get concessions	No. of Tariff Lines
Bangladesh	LDCs	1249
	Non-LDCs	1254
Bhutan	All	157
India	LDCs	763**
	Non-LDCs	884
Maldives	All	671
Nepal	LDCs	1304
	Non-LDCs	1335
Pakistan	All	1183
Sri Lanka	All	1063

Note: LDCs: Bangladesh, Bhutan, Maldives and Nepal.
Non-LDCs : India, Pakistan, and Sri Lanka.
* Total Number of tariff lines at 6-digit HS level are approximately 5224.
** India will give tariff quota on 6 million pieces of fabric to Bangladesh.
Source: India's Regional Trading Arrangements by Rajesh Mehta and S. Narayanan, RIS-DP # 114, Research and Information System for Developing Countries.

Despite the progress of SAPTA and SAFTA, the political insecurity, conflicts among the SAARC as well as animosity towards a surging India are responsible for stalled integration to some extent.

Non-tariff Barriers:

Non-tariff barriers are substantially high among South Asian countries, and continue to pose major hurdles to both intra-regional and inter-regional trade. The South Asian countries have a number of restrictions - over-regulation, safety standards, other safeguards, entry point restrictions, bureaucratic processes, customs procedures, delays in transit due to border issues, no mechanism to reduce NTBs etc which reduce and complicate trading activities or shift formal trade into informal channels. In the early 1990s, India and Bangladesh had the highest non-tariff barrier coverage ratio for primary and manufactured goods (Taneja, 1999). Moreover, India has become a prolific user of anti-dumping duties.

In Bangladesh, certain commodities, such as yarn and textile, are not allowed to be imported across the land border with India and have to be shipped to Chittagong. This increases considerably the import time and cost for imports from India as all containers have to be routed via a hub port such as Singapore. The regulation was designed to protect Bangladesh yarn and textile producers. With the development of a direct container shipping service between India and Bangladesh, the time and cost penalties will have reduced quite considerably but the road route would offer the quickest and lowest cost routing for much of this traffic. Thus the trade barrier remains, though it may have been somewhat lowered.

In Pakistan, the positive list approach to trade with India results in a significant level of misreported trade. Exports from India are routed to Dubai where the good are relabeled and then shipped to Pakistan under a different certificate of origin. Alternatively, the bill of lading may be switched once the goods are on the vessel and are then shipped directly to Pakistan. Such 'switch' bills of lading are illegal but can be obtained at a relatively modest cost. The misreported trade enters into Pakistan as legal trade but from an incorrect origin. This trade is different to the exports from India, which is routed via Dubai, Iran and Afghanistan and then crosses the border into Pakistan by camel or donkey. Such routing is designed to avoid high Pakistan import related taxes and the importers are prepared to pay considerably higher transport costs as well as Afghan

customs duties in order to evade Pakistan's taxation. While still considerable, the flow of informal trade from India into Pakistan is reported to have diminished somewhat in recent years.

The 1996 Indo-Nepal trade treaty gave duty-free access to goods manufactured in Nepal and removed the value addition norms of the previous treaty. Nepalese exports to India grew rapidly but India claimed that some of the exports were effectively only the re-export of third country imports into Nepal. The revised treaty, signed in 2002, re-imposed eligibility criteria and established quotas for four products, exports beyond which would be subject to MFN customs duties. The Federation of Nepalese Chambers of Commerce and Industry will not issue certificates of origin under MFN status, apparently fearing that such trade would endanger duty-free access for other products. These are some instances of informal trade within South Asia caused by different trade barriers.

Sanitary and Phyto-sanitary Standards: In South Asian countries, the SPS standards are far lower than the developed countries standards and therefore the products, especially agriculture products from South Asia, are not acceptable in developed countries. Therefore, to compete with the international standards the level of technical regulations or SPS measures imposed are far higher than the risk involved which provides a trade impeding effect in South Asia. Exporters face problems and thus concentrate on other markets. To maintain/expand trade to developed countries, it will be necessary to improve farming and processing to meet SPS standards and provide the traceability and documentation required.

Entrepreneurs/firms in South Asia report standards and technical regulations are crucial for their export performance. Nepal's carpet and wool industry and many other export industries suffer as they fail to maintain their product quality as par with the international market standards. Nepalese exporters often fail to present "quarantine and health standard certificate" at the border with India. Another example in this regard is Indian coffee industry. Therefore industries in the South Asian region must comply with sanitary and phyto-sanitary measures. Firms also must focus on increasing pressures to comply with national pollution laws to protect biodiversity.

To improve export performance of SAARC countries, harmonization of standards is needed through formulation and implementation of regional standards by integrating national standards, and then adoption of international standards. South Asian countries have recognized the importance of harmonization of standards in the context of trade facilitation. In 1999, SAARC and the European Union signed a Memorandum of Understanding to enhance cooperation to assist the harmonization of SAARC standards (EUROPA 2004). South Asian countries have started to address the issues of standards in bilateral discussion within the region (eg. India and Nepal). The Nepal Bureau of Standards and Metrology tries to harmonize national standards with international standards such as ISO, and provides Nepalese industries with quality assurance services, consignment inspections, and programs of environmental labeling for export industries. Additional efforts are required in Nepal and other countries, many of which can be supported through regional cooperation platforms in standards (World Bank 2007).

The development and mutual recognition of each other's standards among the SAARC countries has become urgent because China has recently become a major trade competitor to all SAARC nations. It is capturing neighboring markets through merchandising innumerable products on a mass scale at cheaper prices. With similar competitive advantages of large domestic markets and low-cost labour supply, South Asian countries could revitalize their own manufacturing and standards to effectively emerge in the same markets as China.

Trade and Transport Logistic: Trade and transport logistic facilities in South Asian are poor and an important concern for policymakers. Dispersed/discrete transport systems throughout the region have made trade facilitation a difficult affair. The region needs serious attention for harmonization of transport systems. The trucks of one country have to reload frequently to cross the border of other countries in the region. This increases the risk of theft and breakage.

Roads in South Asia are poorly maintained and of limited capacity and thus inadequate for high traffic volumes. This makes trade facilitation more difficult as roads are the main

mode of trade in South Asia. Other road related concerns are lack of direct road connections to state capitals, production centers, markets, and ports. Sometimes countries also impose load limits. Thus, it is recommended to increase investments in transport systems and regional corridors. Moreover, countries should introduce and allow regional vehicles with special registration number throughout the region. A harmonized regulatory transport framework is vital to creating a level playing field for transport companies.

All the ports of the region suffer from high turnaround time for ships and costs due to congestion, long queues and lack of unhindered access to the sea. Complicated and nontransparent customs procedures, and high requirements of paperwork and signatures have worsened the situation. However, the customs environment is improving and, in some important respects, South Asia seems to be catching up and even sometimes moving ahead of East Asia. But these improvements are not at similar extent for all the countries in SAARC. This indicates special attention needed for some countries like Bangladesh and Afghanistan.

Table 4.6: South Asia: Customs Clearance

	Customs Clearance	Cargo Inspection	No. of Border agencies	
			Import	Export
India	2.4 days	25 per cent	2.4	2.9
Pakistan	2.4 days	10 per cent	2.9	3.2
Bangladesh	4.1 days	31 per cent	2.3	2.0
Nepal	1.4 days	12 per cent	4.3	5.3
Afghanistan	3.8 days	100 per cent	3.3	2.3

Source: Trade and Transport Facilitation in South Asia: Systems in Transition, World Bank.

Afghanistan performs poorly in comparison with the other countries. Nepal is seen as having relatively speedy customs clearance and low rates of inspection in spite of having the highest number of border agencies involved in the trade process. India and Pakistan show very similar scores for the customs' function, and significantly better than those for Bangladesh.

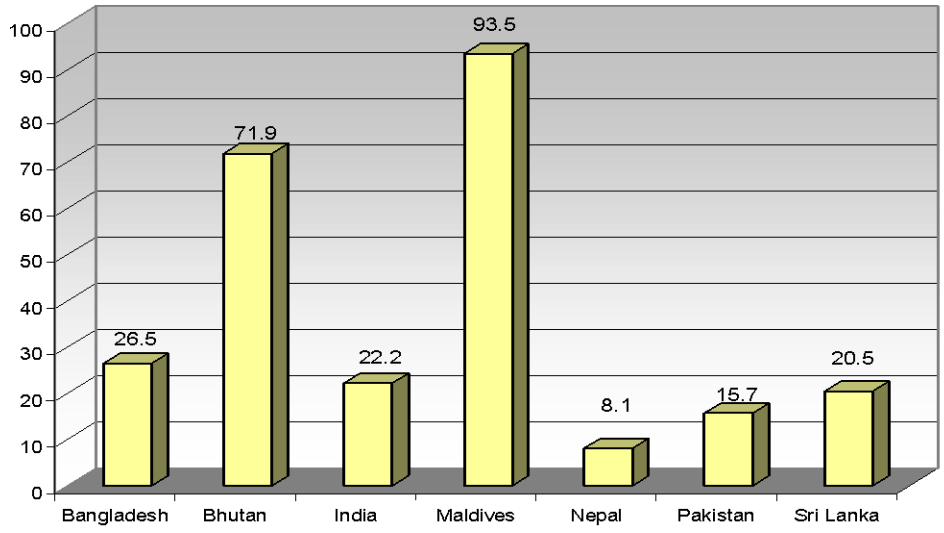
Corridor specific focus is needed in customs reforms as majority of trade is concentrated along few corridors/gateway and ports. This has important implications for intra-regional

trade, which is often along less important trade corridors. Regular monitoring of the customs activities by modern computer based systems is also necessary to track and examine the performance. Customs should be able to produce monthly performance reports. The systems should capture the time from lodging the declaration to release of the cargo, and this information can be combined with other data on the total dwell time to ensure greater efficiency.

In order to continue improving performance, the Customs management needs to establish performance targets. These would reflect what is achievable through on-going reforms and should be periodically updated. The Green Channel use is must for the majority of cargo and most of the documents regarding cargo procedures should be processed electronically. The customs clearance for the shipments needs to be done in the least possible time – 4 to 5 hours for green channel clearance; 2 days for imports and half a day for exports via sea routes; and average 5 hours for airborne export and import. Imports requiring testing should be released under bond and tests must be completed within 72 hours. Systems can also be used to support efforts to professionalise the Customs staff. They can provide information on the performance of individual customs inspectors in terms of their level of activity and the anomalies identified through their efforts.

Political Problems: One of the main reasons of low integration in the South Asian region is political conflicts between the countries. The smaller developing countries are not fully convinced about the regional cooperation agenda, more because of India's growing influence over the world. They fear that a large trading partner like India will dominate the region economically to the detriment of their domestic industries. Political tensions especially between India and Pakistan, the two big members of SAARC, are hampering the atmosphere of mutual trust, confidence and understanding.

Figure 4.1: Political stability



Note: Higher values imply better ratings
Source: Governance Matters: Governance Indicators for 1996-2002, World Bank, 2003.

Apart from these, identical comparative advantage, poor communication links, weak financial systems, weak institutional support, and inefficient governance are some of the other constraints in regional integration in South Asia.

CHAPTER 5

TRADE AND TRANSPORT FACILITATION IN SOUTH ASIA

For successful integration in SAARC, trade facilitation in South Asia has become increasingly important, as regional integration of any region should start with greater intra-regional trade activities. Better trade facilitation means ease in cross-border movement of goods between the countries and thus refers to modernization of customs and easing transport bottlenecks. South Asia is lagging behind its competitors with respect to the efficiency of its trade related transport systems. Clearance times for cargo through the ports are slower in South Asia than in almost any other region. Different studies on trade facilitation and transport logistics in the region illustrate continued weaknesses of countries in port and transport infrastructure, highly protected environments, and poor service-sector infrastructure.

In trade facilitation indicators South Asia lags behind international norms. On average, the region takes 10 days to clear customs by sea, whereas East Asia takes 6 days and developed countries take only 3 days. Increasing the effectiveness of customs can help to reduce costs and increase trade.

Logistics is an important component of trade facilitation but South Asia is well behind the international standards. The logistics sector is largely confined to arrange customs clearance and inland transport for imports, and delivery to port, inland ICD or buyers' warehouse for exports. But recently, the situation has started to improve and specifically in India, the industry is beginning to change, paralleling the increasing complexity of production and distribution.

To improve the logistic performance, the governments of South Asian countries should allow international logistic companies to provide and share their technology and management practices. Both India and Pakistan have adopted an open approach to the participation of the international operators, Bangladesh has been more restrictive with financial requirements that are likely to deter international participation.

National logistics/distribution networks are developing and the replacement of state taxes by VAT should be a major impetus to the streamlining of supply/distribution systems. The development of organized retail chains, with international companies in the supply

activities, will bring further major changes which may have substantial spin-off effects in other sectors. Establishing the networks to supply perishable commodities to domestic retail chains could, for example, be adapted to provide the supply chains necessary to break into the higher value sectors of the export market for fruit and vegetables.

In the SAARC region, most of the corridors and border crossings are characterized by significant delays and higher costs. At any border crossings, bilateral coordination between the two border countries is crucial otherwise delays can be caused by lack of communication between border agencies and non-harmonized and complex procedures. Both gateway and behind-the-border transport and communication services need to be compatible between nations, and technical certifications need to be also simplified.

Land Border and Road Corridors

Most of the trading activities in the South Asian countries are carried out through road transport. The principle road corridors in South Asia region are:

- Delhi-Mumbai
- Delhi-Gujarat
- Bangalore-Chennai
- Guwahati-Siliguri-Kolkata
- Peshawar-Lahore-Karachi
- Dhaka-Chittagong
- Katmandu-Birgunj
- Thimpu-Phuentsholing
- Colombo-Galle

All these corridors are characterized by low capacity, and narrow and congested roads, and are thus inadequate for high traffic volumes. Most of the border posts in South Asia lack adequate communication/coordination link and infrastructure and testing facilities. Requirements for back-to-back exchanges of cargo cause additional delays in customs procedure.

Poor maintenance and inadequate investment result in dismal road condition throughout South Asia. Moreover the road transport system is characterized by low service standards, slow vehicle speeds and therefore high travel times and cost. While railways are suitable for long distance freight and passengers travel, South Asia uses roadways for long distance moves. The governments of South Asian countries began to invest in major inter-urban highways from the mid-1990s but progress has been slow. Two major ongoing initiatives in this regard are Pakistan's Multi-lane highway from Peshawar to Karachi (completion: FY2008) and India's four laning of the Golden Quadrilateral (approaching completion) (World Bank, 2006). Among other proposed initiatives are:

- In Pakistan a limited access road between Karachi and Lahore similar to that between Lahore and Islamabad has been proposed but is not yet under construction.
- Bangladesh is in the process of widening the road between Dhaka and Chittagong to four lanes but there are no plans for a limited access.
- Nepal has considered widening the road between Kathmandu and the Terai but so far traffic levels are too low to justify this investment (World Bank, 2006).

In terms of the total network, the achievements have so far been limited and the region is still a long way from having a modern, high speed inter-urban highway network. However, the recent investments have had a marked impact on some of the key trade corridors. Average truck trip times between Delhi and Mumbai, for example, have been reduced from 5/6 days to 2/3 days, though international standards for a haul of this length might be 24 – 30 hours.

The other problems in logistic sector are:

- Old, inefficient, fragmented truck fleet
- Low-cost transport services hampering the quality of the services
- Limited storage capacities in warehouses/godowns
- Greater involvement of foreign companies in value-added services (consolidation, packaging, and inventory management).

In India and Pakistan, road freight rates especially for bulk cargo are world's lowest, resulted by low cost logistics, high vehicle utilization, massive overloading and relatively low fuel prices. The freight rates may be low, but the overall economic and social costs are much higher due to road damage, impact on other road users, and adverse road safety. The very low freight rates are matched by very low quality service – long transit times, unpredictable delivery, no cargo insurance, etc.

Substantially greater investment will be necessary to provide South Asia with the efficient and suitable highway network to support sustained high levels of economic and traffic growth. Pakistan proposes investments of about US$3.6 billion to upgrade the North-South Highway Corridor and India's National Highway Development Plan envisages the completion of the Golden Quadrilateral at a total cost of about US$50 billion. Unfortunately, the present levels of highway investment in South Asia still face some constraints in terms of availability of funding from public sector so need to move towards private investment. The constraints could be removed/reduced by the participation of foreign companies but while all the major international operators are prepared to invest in South Asian ports, the highway sector attracts very little interest. How the necessary highway investment will be financed and implemented remain unanswered questions; inadequate highways have the potential to limit both economic and trade growth in the region.

One important constraint of road transport system in South Asia is that the trucks of one country are not allowed to collect/deliver consignments in neighboring countries and this therefore requires unloading of cargo from the trucks of the exporting country and again reloading onto the trucks of the importing country. Consequently, at the border, cargo has to be unloaded. Until very recently, there were few, if any, direct scheduled shipping services between the South Asian countries. Therefore South Asia must implement **Cross-Border Trucking system** throughout the region. There are various potential ways that procedures and safeguards to allow cross-border truck movement and the direct delivery of freight might be achieved:

- Limited time entry for cargo delivery

- Route licensing for foreign trucks: A broader solution would be the provision of specific route licenses for foreign truckers without the time restriction.
- Dual country vehicle registration
- Dual registration of semi-trailers – the semi-trailer would be delivered to the border by the tractor unit of one country and then hauled by a tractor unit from the neighboring country.
- Joint venture trucking companies – a more restrictive form of the dual vehicle registration and it would reduce the flexibility and possibly capacity of the system, but could be a major improvement upon the present transshipment of cargo.
- Containerization/swap bodies - cargo can be shifted quickly and cheaply from one vehicle to another, avoiding the costs of manually unloading and reloading trucks.
- TIR or similar - This system would allow the clearance of cargo away from the border, providing a guarantee for the payment of customs duties if cargos are diverted to the domestic economy prior to clearance.
- Vehicle standards - Unless vehicle standards are established and trucks certified as meeting them, vehicle safety/standards could well be used as a barrier to participation by the trucks of a neighboring country.
- Construction of Integrated Check Posts (ICP) involving all regulatory agencies like immigration, customs, border security along with support facilities like parking, warehousing. The Indian Government has now also announced its intention to establish a Land Port Authority with a plan to construct 13 ICP along the Indian borders; 4 ICPs are planned with Nepal, 7 with Bangladesh and 1 each with Pakistan (Wagah) and Myanmar (Moreh).

Rail Services

Railways can offer a more reliable service especially for long distance freight. Since road network is characterized by poor quality and congestion, railway can be a more efficient mode of transport in South Asia. Rail can play a vital role in trading activities particularly for the movement of containers to/from the ports. India (largest), Pakistan, and Bangladesh have extensive rail networks. Improvements in the railway network and services in the SAARC region are now underway or proposed. There have already been significant improvements in the operational and financial performance of Indian

Railways (IR), and the restructuring of both Bangladesh Railways (BR) and Pakistan Railways (PR), giving a greater emphasis to freight, have been proposed and are at the beginning stages of implementation.

Rail transport offers potential for freight along the main trade corridors but exploiting the potential will require considerable investment and, in some railways, a change in the effective priorities of government and railway management. IR already faces severe track capacity constraints along its major corridors and has taken the decision to construct a network of dedicated freight only corridors. These corridors will provide a discrete jump in freight movement capacity with faster services and perhaps heavier, and thus more economic, loads; overall, they offer the prospect of a major role for rail.

Regional Rail Links and Services: In terms of intra-regional trade, rail has the advantages of lower costs, easier border formalities and often, in South Asia, faster transit times compared with road transport. There is presently some intra-regional trade moved by rail but the flows are limited by critical capacity and infrastructure constraints. The potential benefits for intra-regional trade from direct rail transport are very considerable:

- To move a 40 ft container from Delhi to Lahore, via JNPT and Karachi, presently costs in the region of US$2,400: a direct rail movement between Delhi and Lahore would cost less than US$1,000.
- To move a 20 ft container from Ludhiana to Dhaka via JNPT costs about US$2,200 and takes 30 – 40 days: direct rail transport of the container would cost about US$1,400 and take 9 – 10 days.

Some measures to improve regional rail links and services in the South Asian region are:

- The physical infrastructure and operating assets must be accompanied by appropriate cost-effective interchange agreements which allow the wagons of one country to move on the network of the neighboring railway. Such agreements need to provide both flexibility and compensation for wagon use. The present wagon balance system,

between IR and PR, is too restrictive and no railway wants to see their wagons accumulate within the system of a neighboring railway.

- Cross-border wagon tracking systems may also be desirable both commercially, so that shippers know where their consignments have reached, and operationally, so that wagons do not get lost on the system of the neighboring railway.
- The two important priorities are raising the level of capacity and efficiency of cross-border rail freight movement and improving rail's competitive position.

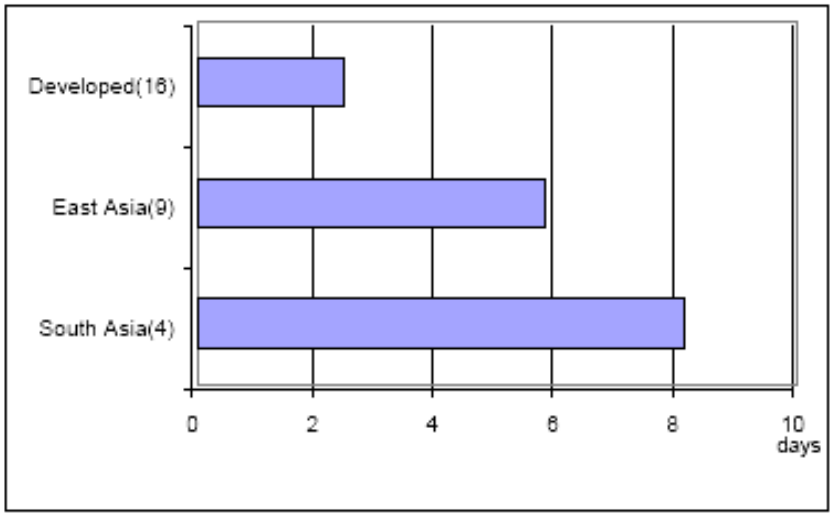
Key to the success of achieving the freight objectives will be the creation of effective freight business units with effective control over their operating assets (both motive power and rolling stock) and designated train paths.

Ports

Most South Asian ports are suffering from congestion and outmoded infrastructure. But recently, the ports have experienced significant improvement in container traffic matching with rising capacity and productivity. Efficient container facilities and systems are critical for the growing exports of garments, textiles and other higher value goods, but the great majority of South Asia's trade, both imports and exports, is low value traffic, particularly fuels and minerals, handled by bulk shipping. Cargo handling for such traffic meets international standards, in terms of loading and unloading rates, and ship charter rates are comparable to those of the region's competitors.

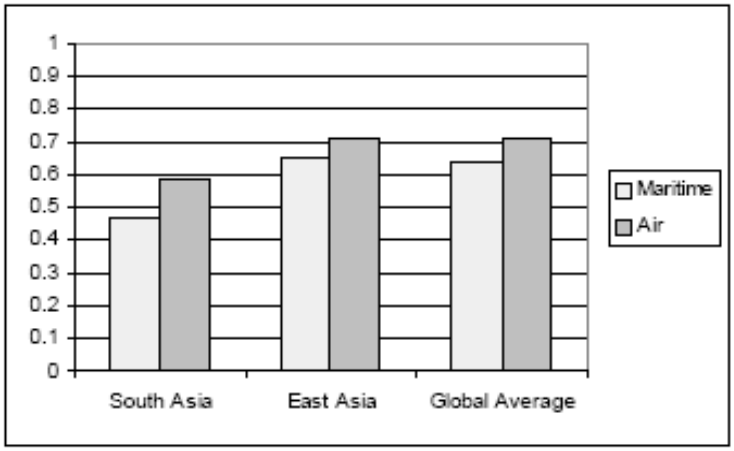
At many South Asian ports, handling productivity has improved and reached international levels but average container dwell times remain well above international norms. Customs clearance is generally no longer the major source of delay that it used to be, although inadequate documentation may delay some containers for extended periods. The long dwell times appear the result of a number of factors: long free storage periods at some ports; inadequate inland transport capacity to move containers to inland container depots (ICD) for clearance; and the lack of direct delivery from the berth. Long average dwell times can have significant economic costs – congested container yards feed through to reduced port productivity and thus the need for additional terminal investment, despite low berth occupancy.

Figure 5.1: Average Days Required For Customs Clearance By Sea



Source: World Bank, 2004.

Figure 5.2: Port Efficiency Indicators (maritime and air)



Source: WMO database, 2004.

Shipping:

According to the World Bank database, container traffic in India's major ports was 3.9 million in FY04 and is expected to reach 7 million TEUs by 2007. Pakistan and Sri Lanka's traffic has experienced slower growth, but the former accelerated significantly in the last few years. Sri Lanka has been dependent on transshipment traffic and has experienced increasing competitive pressure over the last decade. South Asia has a time and cost advantage in terms of freight rates over China for destinations in Europe and the US East Coast but a substantial disadvantage on the US West Coast routes; the world may be shrinking, in many ways, but distance still counts (World Bank, 2006).

The necessary initiatives to meet the demands of both the shippers and shipping lines and make the ports more competitive are:

- Lower port charges to increase service frequency and therefore competitiveness.
- Increase in Port capacity
- Increase in Port channel and berth drafts
- Higher port productivity.

REGULATORY IMPEDIMENTS

Regulatory impediments at the gateways and border crossings are also critical concern to both regional and international trade in South Asia. The main obstacle at the border crossings is the cumbersome and non-transparent custom system. Recently, some reforms in customs procedures have been started.

The reforms in customs are performed by replacing the manual systems for trade processing and customs clearance by automated computerized systems. This would require adequate investment in reliable power and communication networks. The modern custom system would minimize the personal interaction between the officials and traders and therefore reduce the levels of corruption. Streamlining customs procedures and reducing the costs of formal trade should help to shift some of the present informal trade to official channels.

The introduction of inland customs procedures will allow customs clearance away from the border and will be beneficial as this will avoid congestion, unnecessary extra investment, operating costs and delays associated with land port facilities. South Asian countries have procedures to allow customs clearance at an inland destination, away from the entry seaport. But, except in Afghanistan, the use of the inland customs clearance system is very limited. Besides this, the use of scanners to check containers for illicit or non-declared cargo without stripping at the border is also needed.

However, the reforms in customs have not followed a similar pattern in all the SAARC countries but proceeded in a dispersed way. For example, India has moved to almost a paperless system with the last remaining step being the electronic signature on the

customs declaration, while Nepal has only really adopted the revenue and statistic modules of ASYCUDA and the clearance system itself remains largely manual. Pakistan has also started implementation of integrated trade community system. Therefore on average, the advancement in modernization of customs during last few years has been fairly noteworthy.

Initiatives needed to improve the customs procedures in SAARC Region are as follows:

- Computer based customs system to monitor and track cargo related information and this will minimize corruption level and bureaucratic inefficiency.
- Implementation of Automation (ASYCUDA) in major Customs
- Implementation of green channel facilities to ease the cargo examination norms.
- Implementation of Pre-Shipment Inspection (PSI) facilities and reliance on self-declaration and risk management systems.
- Cooperation/harmonization in customs related matters
- Improve exchange of information on markets and legal environment—information on standards; import rules; investment opportunities; and opening of trade body offices in SAARC member countries.
- Introduction of "single window" operations to provide a one-stop shop to the trader to fulfill all export, import and transit related regulatory requirements
- Introduction of joint border facilities/management (single agency to facilitate and regulate customs operation).
- Establish a trade inspection system with good regulatory practices.
- Cooperation between quality inspection organizations.

South Asian region is one of the lowest performers according to the World Bank's trading across border rankings. The transaction costs involved in meeting the procedural requirements for exporting and importing, (i.e. the number of documents needed to export or import, signatures needed to export or import, and days it takes to export or import) are much higher in South Asia compared to East Asia and other developed countries. South Asia takes on average 33 days to export from South Asia compared to 12 days from OECD countries and more than 32 days to import into South Asia compared to 14 days for OECD.

Table 5.1: Trading Across Borders (2007)

Country	Rank	Documents for exports (number)	Time for exports (days)	Cost to export (US$ per container)	Documents for imports (number)	Time for imports (days)	Cost to import (US$ per container)
Afghanistan	174	12	67	2,500	11	71	2,100
Bangladesh	112	7	28	844	9	32	1,148
Bhutan	149	8	38	1,150	11	38	2,080
India	79	8	18	820	9	21	910
Maldives	110	8	21	1,200	9	20	1,200
Nepal	151	9	43	1,600	10	35	1,725
Pakistan	94	9	24	515	8	19	1,336
Sri Lanka	60	8	21	810	6	21	844
South Asia		8.6	32.5	1180	9.1	32.1	1417

Source: Doing Business 2008, World Bank Group.

The capacity building in infrastructure and logistics to facilitate trade in South Asia - or any other region – involves huge amount of investment. Better trade facilitation therefore involves better investment climate, efficient regulation system, access of technology and skills to modernize customs procedures along with the capacity building. A World Bank study estimated that considering intraregional trade if countries in South Asia raise capacity half to East Asia's average trade, total raise is by US$2.6 billion. This is approximately 60 percent of the total intraregional trade in South Asia. If South Asia and the rest of the world raised levels of trade facilitation halfway to the East Asian average, gains to the region are estimated at US$36 billion. Out of these gains, about 87 percent of the total gains to South Asia will be generated by South Asia's own efforts (leaving the rest of the world unchanged). The important role of India in advancing reform should also be noted. India also has to play a leading role as it represents 80 percent of total GDP in South Asia and can act as a catalyst to advance a trade facilitation agenda (World Bank, 2006).

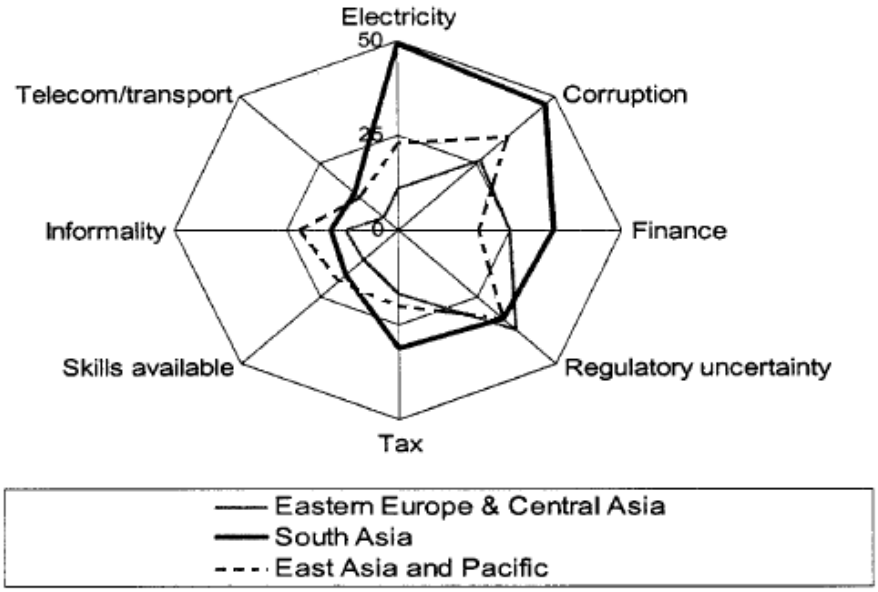
CHAPTER 6

INVESTMENT CLIMATE AND COST OF DOING BUSINESS IN SOUTH ASIA

A competitive investment climate is important for a region's growth performance and prosperity. Better trade linkages also depend on a country's/region's business climate. Strong investment climate crowds in larger volume of investment in different sectors and therefore can lead sustainable and inclusive growth throughout the region. Therefore, in South Asia, to sustain the recent strong growth performance over the longer term, it is crucial to improve investment/business climate and increase competitiveness. A better investment climate includes better infrastructure and logistic services, strong financial, legal and institutional framework, efficient labour market and better governance.

But, unfortunately the SAARC region is characterized by weak investment climate caused by factors like low access to infrastructure and power, limited access to finance, high level of bureaucracy and red tape (with associated problems of weak governance and corruption) and labour market inflexibility.

Figure 6.1: Share of South Asian Firms Reporting the Issues as a "Major" or "Severe" Constraint on the Operation of Their Business



Source: Investment Climate Surveys.

The Global Competitiveness Index Report publishes a Business Competitiveness Index (World Economic Forum 2007). In 2007-08, India ranked forty-eighth, Sri Lanka

seventieth, Pakistan ninty-second, Bangladesh hundred and seventh and Nepal hundred and fourteenth out of 131 countries according to the perceptions of expert respondents. The report then details specific areas of relative strengths and weaknesses for each country. The factors identified as "most problematic" for doing business in the region were strikingly similar across the countries.

Infrastructure

Inadequate physical infrastructure is the major constraint to investment climate and business activity in the SAARC region. Among them, shortages and unreliable power supply, less access of railways for trading activities, and congested ports are prime concerns.

Electricity: The most serious bottleneck in infrastructure is access to electricity. According to the World Bank's Investment Climate Surveys, more than 40 per cent of firms in South Asia complain of power shortages and breakages as a major constraint in business. To get a new connection, South Asia requires 55 days whereas it takes only 7 days in the Philippines or 10 days in the PRC. In South Asia, 63 per cent of firms have installed costly generators which provide 15 per cent of electric consumption whereas in Thailand, generators provide only 3 per cent of electric consumption and in the PRC 18 per cent of firms installed generators providing mere 2 percent of electric consumption. Problems regarding power supply are most acute in Bangladesh, where 70 per cent firms complain of electricity as the critical constraint of business activity and suffer average 249 electrical outages in a year. In India, 25 per cent of firms identify electricity as a major problem of business. South Asia loses a higher portion of output due to power losses compared to other regions in the world. Due to power problems, Bangladesh loses 3.3 percent of sales, Pakistan 5.4 percent, India 5.5 percent whereas China loses only 2.2 percent of sales. The losses due to power shortages also vary within the countries as in India; Bangalore loses 2 percent of sales, similar to China, whereas Kolkata loses 6 per cent of sales (World Bank, 2006).

Transport: Transport infrastructure including road, rail, maritime and air transport is another major obstacle to investment and business activities in South Asia. Roads in

South Asia are narrow, congested and inadequate for high traffic volume. The quality of roads remains poor and inappropriate for modern long distance heavy-loaded trucks. Moreover, South Asia lacks intra-regional connectivity between the national road systems. Low investment and more preference for passenger traffic are the main concerns for railway system in South Asia. Though rail can be an efficient mode of transport for cargo especially high value added containers, roadways account for about 70 per cent of trade transport in South Asia. Maritime transport is constrained by inadequate capacity and inefficient port facilities. The main ports of South Asia are not well connected by rail or road to the hinterland. Air transport also faces capacity constraints including shortage of runways, parking, and cargo processing facilities. Transport infrastructure in SAARC region needs urgent sector specific reforms. SAARC region takes higher time and cost to trade goods compared to countries in ASEAN 4 and the PRC. However, according to the Doing Business 2008, World Bank, recently SAARC nations (except Afghanistan, Maldives and Nepal) are improving in trading across borders indicators (see Table 5.1). The recent progress is due to the policy reforms instigation in various transport areas. India has initiated policy reforms in roads, ports, airports, and urban sectors and this involves huge investment under public-private partnerships.

Bureaucracy and red tape (including problems of weak governance and corruption)

Bureaucracy, red tape and weak governance are other great concerns after infrastructure in the SAARC region as a whole. To conduct business activities provision of some government services are required. But the South Asian firms suffer from inefficiency in government services at varying amounts that are less than 30 percent to 60 percent in Pakistan, Sri Lanka, and Nepal. The requirement of government services in business activities involves greater waiting time; for example, a new phone connection takes 35 days in India and 130 days in Bangladesh. Higher restrictions/regulation for business activities, greater involvement of government personnel, greater bureaucracy and red tape leave scope for corruption. Across the region, bribe payments vary between 2.2 and 2.5 percent of sales. Firms/entrepreneurs in the SAARC region confront over-regulation at the time of setting up, running or closing down a business enterprise. Administrative requirements like permit, licenses, paperwork and regulation norms issued by the

governments make the system more complicated. The costs associated with the process of administrative and government regulations are much higher in South Asia than in the China and Southeast Asia. The following tables (6.1 to 6.3) illustrate the requirements of procedure, duration and cost involved in starting and closing a business and dealing with licenses in South Asia in comparison with other regions of the world.

Table 6.1: Starting a Business

Region or Economy	Procedures (number)	Duration (days)	Cost (per cent GNI per capita)	Min. Capital (per cent GNI per capita)
East Asia & Pacific	8.7	46.8	34.7	50
Europe & Central Asia	8.8	26.2	11.1	45.3
Latin America & Caribbean	9.8	68.3	43.6	13.1
Middle East & North Africa	9.7	38.5	66	487.7
OECD	6	14.9	5.1	32.5
South Asia	7.6	33.4	40.7	0.7
Sub-Saharan Africa	10.8	56.3	148.1	188.8
Afghanistan	4	9	84.6	0
Bangladesh	8	74	46.2	0
Bhutan	8	48	10.4	0
India	13	33	74.6	0
Maldives	5	9	13.4	5.8
Nepal	7	31	73.9	0
Pakistan	11	24	14	0
Sri Lanka	5	39	8.5	0

Source: Doing Business, 2008, World Bank Group.

Table 6.2: Dealing with Licenses

Region or Economy	Procedures (number)	Time (days)	Cost (per cent of income per capita)
East Asia & Pacific	19.4	175.3	177.2
Europe & Central Asia	24	251.3	628.4
Latin America & Caribbean	16.9	238.6	268.2
Middle East & North Africa	19.4	201.4	445.7
OECD	14	153.3	62.2
South Asia	16.3	247.3	3,230.00
Sub-Saharan Africa	18.1	262.5	2,549.20
Afghanistan	13	340	21,230.80
Bangladesh	14	252	751
Bhutan	25	183	195.9
India	20	224	519.4
Maldives	9	118	39.9
Nepal	15	424	304.7
Pakistan	12	223	869.5
Sri Lanka	22	214	1,929.00

Source: Doing Business, 2008, World Bank Group.

Table 6.3: Closing Business

Region or Economy	Time (years)	Cost (per cent of estate)	Recovery rate (cents on the dollar)
East Asia & Pacific	2.7	23.2	28.1
Europe & Central Asia	3.2	13.7	28.9
Latin America & Caribbean	3.2	16.4	25.9
Middle East & North Africa	3.7	13.9	25.8
OECD	1.3	7.5	74.1
South Asia	5	6.5	20.1
Sub-Saharan Africa	3.4	20	17.1
Afghanistan	no practice	no practice	0
Bangladesh	4	8	23.2
Bhutan	no practice	no practice	0
India	10	9	11.6
Maldives	6.7	4	18.2
Nepal	5	9	24.5
Pakistan	2.8	4	39.1
Sri Lanka	1.7	5	44.6

Source: Doing Business, 2008, World Bank Group.

In South Asia, the complexity of the taxation system is another feature of weak regulatory framework. Numerous exemption and exclusion rules complicate the tax system further and leave scope for tax avoidance and evasion.

Table 6.4: Paying Taxes

Region or Economy	Payments (number)	Time (hours)	Profit tax (per cent)	Labor tax and contributions (per cent)	Other taxes (per cent)	Total tax rate (per cent profit)
East Asia & Pacific	27.4	271.5	18.2	10.5	9.8	38.5
Europe & Central Asia	46.3	451.5	11.2	28.7	10.8	50.8
Latin America & Caribbean	39.4	406.6	21.8	14.5	11.7	48
Middle East & North Africa	25.1	236.8	14.7	16.5	5.2	36.4
OECD	15.1	183.3	20	22.8	3.4	46.2
South Asia	30.6	305.5	19.5	7.5	14.3	41.4
Sub-Saharan Africa	38.7	321.2	21.4	13.3	33.3	68
Afghanistan	6	275	0	0	35.5	35.5
Bangladesh	17	400	30.3	0	9.2	39.5
Bhutan	19	274	34.2	1.1	4.4	39.8
India	60	271	19.6	18.4	32.5	70.6
Maldives	1	0	0	0	9.1	9.1
Nepal	33	408	20	11.3	1.3	32.5
Pakistan	47	560	25.8	12.6	2.3	40.7
Sri Lanka	62	256	26.5	16.9	20.4	63.7

Source: Doing Business 2008, World Bank Group.

Customs administration: South Asia suffers low integration along with higher costs of transportation and trading across borders. Theft and breakages that occur during the transportation of goods to market increase costs. Repeated inspection and poor infrastructure conditions result in delays in transportation. Overall complex customs formalities with requirement of excessive number of signatures/paperwork, lack of computerization in customs worsen the condition. Many steps in customs clearance require manual intervention, including extensive physical examination of goods.

Labor market inflexibility

According to World Bank's Doing Business indicators, the SAARC nations have some of the most stringent requirements for labour market functioning. From a regional perspective, South Asia is worst in terms of difficulty of hiring and firing labor than any other region of the world (except sub-Saharan Africa).

Table 6.5: Employing Workers

Region or Economy	Difficulty of Hiring Index	Rigidity of Hours Index	Difficulty of Firing Index	Rigidity of Employment Index	Nonwage labor cost (per cent of salary)	Firing costs (weeks of wages)
East Asia & Pacific	19.2	20.8	19.2	19.7	9.4	19.2
Europe & Central Asia	36.3	51.4	32.1	40	25.4	36.3
Latin America & Caribbean	36.9	35.5	24.5	32.3	12.7	36.9
Middle East & North Africa	25.8	42.4	31.2	33.1	14.8	25.8
OECD	25.2	39.2	27.9	30.8	20.7	25.2
South Asia	23.6	17.5	40	27	6.7	23.6
Sub-Saharan Africa	41.7	43.9	42.2	42.6	12.3	41.7
Afghanistan	0	40	30	23	0	0
Bangladesh	44	20	40	35	0	44
Bhutan	0	0	20	7	1	0
India	0	20	70	30	17	0
Maldives	0	0	0	0	0	0
Nepal	67	20	70	52	10	67
Pakistan	78	20	30	43	11	78
Sri Lanka	0	20	60	27	15	0

Source: Doing Business 2008, World Bank Group.

Access to Finance and Financial services

Efficient and easy access to finance and financial services is a must for successful business and investment climate in a region. But in South Asia, procedures for obtaining finance or credit are very cumbersome and time consuming. Government plays a

dominant and decisive role in the financial sector of all South Asian countries. Therefore, access to finance repeatedly comes up as a concern for entrepreneurs. The rate of formal bank loans is fairly limited. Sometimes overdraft facilities are provided but with limited credit. According to the World Bank report (2006), the share of firms that have overdraft facility varies from 18 to 23 percent in Pakistan to nearly 60 percent in India, Bangladesh, and Sri Lanka. Further the banking activities in South Asia require higher time than other regions of the world. For example, clearance of cheques takes 2 days in Pakistan, 3 days in Bangladesh, 4 days in China, and 11 days in India (World Bank Database).

Table 6.6: Getting credit

Region	Legal Rights Index	Credit Information Index	Public registry coverage (per cent adults)	Private bureau coverage (per cent adults)
East Asia & Pacific	4.5	1.9	5.5	10.8
Europe & Central Asia	5.6	3.4	2.4	15.4
Latin America & Caribbean	4.1	3.4	8.1	32.1
Middle East & North Africa	3.7	2.6	3.6	8.1
OECD	6.4	4.8	8.6	59.3
South Asia	3.9	1.9	0.7	1.9
Sub-Saharan Africa	4	1.3	2.1	4.5
Afghanistan	0	0	0	0
Bangladesh	7	2	0.7	0
Bhutan	3	0	0	0
India	6	4	0	10.8
Maldives	4	0	0	0
Nepal	4	2	0	0.2
Pakistan	4	4	4.6	1.4
Sri Lanka	3	3	0	2.9

Source: Doing Business 2008, World Bank Group.

Distributional Impact of a Weak Investment Climate

Weak investment climate associates with low total factor productivity of firms. So better investment climate is desirable for any region's growth agenda. Despite past progress, the SAARC countries suffer from higher cost of doing business due to higher level of corruption, bureaucratic harassment, power outages and shortages in power supply, low

knowledge base (except India's progress in high-skill services); and limited access to infrastructure and government services.

Therefore, South Asia must concentrate on the second-generation policy reforms agenda. Recently, the policy makers have focused on specific areas such as reducing the cost of doing business, improving institutional structure, providing better infrastructure services and therefore improving competitiveness. The main initiatives include better institutional and government agencies/arrangements to mitigate corruption and other bureaucratic harassments; introducing transparency through better disclosure and market discipline; and encouraging private and public partnerships in the provision of infrastructure services. Reforms in investment climate can attract more investment and business in the region and therefore secure a high sustainable growth rate in South Asia in the future.

According to a World Bank Report on Regional Perspectives - South Asia (2005), "The potential returns to investment climate improvements are large… In India, firms in states with poor investment climates have 40 percent lower productivity that those in states with good investment climates. And, if the climate for firms in Dhaka matched that of Shanghai, Dhaka could reduce its productivity gap by 40 percent, and wages could rise by 18 percent. For Calcutta, the effect is even larger: 80 percent of the productivity gap could be closed and wages could rise by 38 percent".

CHAPTER 7

KEY REFORM AREAS

The primary areas that need attention for fostering regional integration are:

- Trade facilitation
- Infrastructure
- Development of service sector
- Building a facilitative business/investment climate, and
- Expanding role of the private sector

Trade Facilitation

Trade facilitation has been a key priority for developing countries and LDCs within the SAARC as the ability of member countries to deliver goods and services on time at lowest possible costs is a key determinant of their intra-regional integration. With the dismantling of trade barriers and the expansion in the volume of trade, policies that remove non-tariff barriers and expedite the movement of goods and services across borders i.e. facilitate trade have emerged at the forefront of the trade agenda.

The ambit of Trade Facilitation is very broad and touches upon several areas. While some of these fall directly under initiatives that need to be taken by the Government, others involve a partnership between private stakeholders and Government initiatives. The main indicators of trade facilitation and the areas of reform required in them are briefly presented below (Jayanta Roy, 2005).

- ***Port Logistics***
    - Cargo Dwell time
    - Warehousing facilities (including refrigerated warehouses for perishables)
    - Rail and road links from hinterland to ports
- ***Customs Procedures***
    - Electronic Data Interface (EDI)
    - Signatureless, Internet based process for filing customs related documents.
    - Trust based systems
    - Post clearance audit
    - Pre Shipment Inspection Agreements (PSI)
    - Risk analysis and assessment

- ***Standards Harmonization***
    - Reform of domestic Standards setting and monitoring authorities
    - Moving towards regional and global convergence on standards
    - Mutual Recognition Agreements on standards
- ***Business Mobility***
    - Movement of Professionals and transparent visa systems
    - Adequate Financial systems including Banking, Insurance and Clearance mechanism
- ***Trade Information and E-business facilities***
    - Proper channels and access to market information, legal systems and standards and regulations
    - Availability of information electronically through the internet
    - E-Business infrastructure to enable to business to business contacts
- ***Administrative Transparency and Professionalism***
    - Simple and transparent procedures for export and import
    - Non-discriminatory approach to enforcement based on risk assessment techniques
    - Public Private cooperation and information sharing to improve enforcement and compliance.

Initiatives needed in trade facilitation:

- Corridor specific focus is needed as majority of trade is concentrated along few corridors.
- Effective bilateral and multilateral trade and transit agreements are needed to diversify trade basket and reduce informal flow of trade (e.g Indo-Nepal Trade and Transit Agreement).
- Bilateral and regional arrangements are needed to allow the vehicles of South Asian countries throughout the region.
- Need to recognize the importance of cost effective rail transport and allow commercial operators to participate in the provision of unit container train operations

- Intercity high-speed, high-capacity, cost effective, and minimal roadside friction expressways are necessary for long distance and modern trucking operations.
- Private sector involvement in building infrastructure and logistics is needed.
- Implementation of Automation (ASYCUDA) in major Customs.
- Simplification and harmonization of border customs procedures is critical.
- Proper documentation is needed. Publication of documentation & procedures on web sites and advance notice to stakeholders before making changes in any rules and regulation are urgently needed steps.
- Common stand at WTO on trade facilitation should be taken by all SAARC countries.
- Establish national trade facilitation bodies and trade nets, and linkages between these through a regional trade facilitation body.
- Introduce Mutual Recognition Agreements on Standards as a signal towards removal of all non-tariff barriers with each other.

According to the paper 'Potential Consequences and Benefits of Implementing a Multilateral Approach to Trade Facilitation' by Dr. Jayanta Roy, perhaps the most important issue is to do with resources and capacity building. South Asian countries like Bangladesh and Pakistan will require enormous resources to upgrade their entire trade related infrastructure and institutions in keeping with the holistic agenda of trade facilitation.

It is precisely for this reason that effective implementation of trade facilitation reforms for larger countries like India is even more of concern. Given India's sheer geographical spread, the number of ports, airports and land entry points (many of them small and ill equipped), the relative diversity of goods and services traded (by developing country standards), the task of implementation of an trade facilitation related program is enormous. Needless to say, the requirement in terms of technology, investment and manpower is also equally huge. Without effective capacity building help from developed countries, large emerging states like India and smaller developing countries with severe resource constraints like Bangladesh will find it difficult to implement reforms related to trade facilitation in a holistic manner.

Trade facilitation came rushing to the foreground of WTO issues as the international business community increasingly expressed concern for greater transparency, efficiency, and procedural uniformity of cross-border transportation of goods. Developing countries of SAARC have legitimate concerns over the exact nature and framework of any multilateral initiative on Trade Facilitation, and these need to be accommodated to move the agenda forward. Some suggestions are:

- Effectively delink Trade Facilitation from the Singapore Issues (i.e. total unbundling). Trade Facilitation should be a stand-alone issue, not even linked to Government Procurement (let alone investment and competition).

- Address developing country concerns on use of Trade Facilitation as a NTB by incorporating a detailed (and obligatory) mechanism for Special and Differential Treatment (SDT).

- Deal with the issue of resource constraints in small developing countries and the sheer scale of requirements large emerging countries head on. Create effective capacity building and assistance measures.

South Asia has a lot to gain from investing in trade facilitation measures through greater customs cooperation, streamlining regulations, introducing technology etc. According to a study by Walkenhorst and Yasui, welfare gains as a result of a 1 percent reduction in trade transaction costs are estimated to amount to about US$40 billion worldwide. Hummels estimates that one day less in delivery times, whether associated with waiting time in ports or delays in custom, on average around the world reduces landed costs of goods by 0.8 percent. If developing countries were to shave off an average of 1 day in the time spent handling of all of their trade, the savings would amount to some US$240 billion annually (Jayanta Roy, 2005).

Infrastructure

Better access to modern infrastructure - particularly electricity, telecoms, roads and ports is crucial for better trade and transport linkages, and better regional integration in the SAARC region – or any other regions of the world. Infrastructure coverage and quality of infrastructure in South Asia is one of the worst in the world. Based on the data of World Development Indicators, South Asia ranks the last in terms of access to physical infrastructure indicators among all regions of the world. In some indicators like mainlines coverage, electricity generation, access to water sources and sanitation, South Asia is barely ahead of Sub-Saharan Africa region. The statistics show that the region lacks access to 24/7 piped water and sanitation facilities. In terms of telecommunications, the region especially the rural areas are not well connected. For example, in Pakistan urban tele-density is 28 per 1,000 households versus 0.9 for rural areas. Rural access to all-season roads is as low as 39 per cent in Bangladesh and 30 per cent in Nepal (World Bank, 2006). But the countries in the region are improving.

Table 7.1: Infrastructure stocks in South Asia, East Asia, and China, 2003

Sector	Unit	India	China	South Asia	EAP (2000) [a]	Latin America and the Caribbean
Electricity generation capacity	Million kilowatts	126.3	356.1	151.9	66.5	
Paved Roads	Km per 1000 km^2	267.2	171.6	227.5		
Rail Routes	Km per 1000 km^2	19.2	6.3	14.6		
Mainlines	Lines per 1,000 hab	46.3	209.0	38.9 (35)	49.0 (76 in 2003)	192.0
Mobile	Lines per 1,000 hab	24.7	215.0	22.6 (37)	48.0 (96 in 2003)	249.0
Access to improved water[b]	Per cent of population	88 (86)	77.0	86 (72)	75.5	90.0
Access to improved sanitation	Per cent of population[a]	34 (30)	44.0	39 (48)	60.0	77.0

Notes: (a) Infrastructure stocks for EAP countries do not include stocks of China. (b) Water and sanitation figures correspond to 2002.
Sources: EAP Infrastructure Flagship, World Development Indicators, and SASEI databases.

Establishing reliable and efficient multi-modal transport network within SAARC region will promote regional cooperation and boost economic development of South Asia. Therefore, there is urgent need to bridge the connectivity gap faster in the SAARC region. The main constraint of building capacity in the region is scarcity of resources. The countries should redouble their efforts and investments to put in place adequate physical infrastructure so as to grow and catch up with the developed economies.

Issues in Infrastructure Development

- Lack of infrastructure is a common problem of the region and poses major obstacles to higher growth. Shortage is both quantitative as well as qualitative
- There is need for extensive modernisation as well as creating additional facilities. Without massive investment from the private sector, there is little hope of adequate development.
- Political environment has been also holding back progress in infrastructure reform.
- Much of the difficulty has been in power sector reforms, particularly in India. These are compounded by the inefficiencies of public sector units such as State Electricity Boards in India. Typical problems in this context are: political interference, cross subsidisation, high T & D losses, poor billing and collection, etc.
- Non-electrical energy sector changes have been relatively smooth, but adequate investments are not forthcoming and lack of cooperation is holding back appropriate utilisation of resources available in the region e.g. natural gas.
- Significant developments are taking place in the field of telecommunication. But there is a huge challenge of modernisation and facilitating intra-regional connectivity.
- So far as roads are concerned, to attract adequate investment, there are several issues that need to be addressed such as appropriate user changes, supporting policies, legal adjustments, etc.
- So far as railways are concerned, network is large but the system needs massive modernisation. Viability of the system is also a major issue.
- Similarly region wise cooperation amongst the maritime nations in the region will go a long way in enhancing intra- regional trade, besides promoting tourism and opening up many other development opportunities
- Civil aviation is poor and inefficient in the entire region and needs a regional policy.

- Rail transport has an important role in the transport of containerized trading activities but need private sector participation.

It is well understood that road transport is a vital mode for transport of imports and exports within the countries in South Asia. But it is also essential to simultaneously develop other modes of transport like rail service, which not only reduces the high demand of road transport but also provides a more fuel effective transport way over long distances. The railroads in Pakistan, India, and Bangladesh are all developed but have not yet reached the stage of true international standard container haulage services, because priority is given to passenger railroads instead. To reverse the situation, it is important that the governments must give priority to rail transport in trading activity intra-regionally or inter-regionally and to allow commercial operators to participate in the provision of unit container train operations.

For improvements in road transport and reduction of regulations on roads, improvements in road network with higher investment are urgent. The construction of intercity expressways is also recommended. This would allow high-speed travel with minimal roadside friction over a long distance and thereby boost modern trucking operations. Further, the process of harmonization of the trucking regulation and the resultant improvement in the efficient synchronization of trucking services will be beneficial for the other supply chains.

Seaports always remain the most important for international trade but are also plagued with delays and other problems. Considerable improvements can be achieved through introduction of private sector in maritime and port activities and by transforming the port sector to a system of small landlord authorities overseeing privately developed and operated terminals. This would improve the efficiency of operations by creating competition in cargo handling services and attract better shipping services.

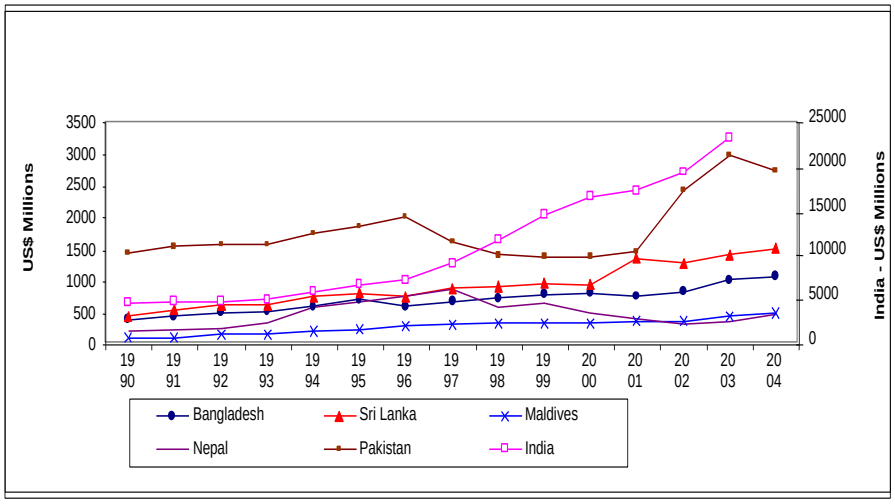
Information and Communication Technology (ICT) for cargo movement monitoring is necessary for quickening the transactions involved and improving the performances of transport and their logistic assets. Another advantage of these systems is that they can

lend themselves to scaling very easily and can be applied by small enterprises including both producers as well as by logistics service providers simultaneously. ICT has already been put to good use by small-scale manufacturers and truck owners benefiting them positively in cost accounting and efficient use of resources. These enterprises, though small in size, number enough for viable development of common commercial software.

Development of Services Sector

The performance of the services sector is vital for development in South Asia since it accounts for over 50 percent of GDP in all South Asian countries except Nepal. Inadequate services hurt South Asians not just in their role as consumers, but also perpetuate poverty by undermining the productivity of firms and farms as well as their ability to engage in trade. Most South Asian countries are currently engaged in services trade negotiations, in the WTO under the General Agreement on Trade in Services (GATS). Barriers to intra-regional trade are even more restrictive in services than in goods resulting in missed opportunities for mutually beneficial trade. But, compared to the proportion of services in GDP (i.e 60 per cent of global output), trade in services in South Asia is very low – only 20 per cent of global trade in services.

Figure 7.1: South Asia Services Exports



Source: World Bank, 2004.

Reasons behind the low share of trade in services & limited liberalization in services:

- Complex domestic regulations like licensing, standards, restrictions, etc hamper services trade in South Asia. Reforming outdated regulations and introducing market-friendly systems is a complex time-consuming exercise.
- The trade liberalization of South Asia did not include services reform, but was only confined to goods. Currently, the region is involved in liberalization of trade in services under GATS.
- Infrastructure bottlenecks i.e. lack of transport and communication connectivity lower trade in services. For example, BPO needs an improved telecommunication linkage within the region and also with the outside world.
- Sometimes, bilateral trade agreements help increase in services trade along with trade in goods. For instance, the India-Sri Lanka Bilateral Free Trade Agreement (ILBFTA) has triggered Mode 4 services trade between the countries.
- Services liberalization should also strengthen domestic services and make them more competitive and lead to lower prices and better quality of service to the consumer.
- The regulation norms for Mode 4 services especially for professional services are weak, clumsy and not well defined. Therefore, a Mutual Recognition Agreement (MRA) is needed.
- The small countries in South Asia fear that if services trade is brought under the regime of SAFTA, India will accrue all the benefits and dominate the region as it has high growth in services sector. South Asian countries must use services liberalization as an opportunity to cooperate with India rather than taking it as a threat. Bangladesh has already started improvement in the BPO services by sub-contracting some of the work given to major Indian service-exporters.
- South Asia is one of the worst performers in millennium development goal (MDG) indicators.

Services Reform

The liberalization of trade in services involves reforms in government policy measures and regulations. It is an information intensive process but in the SAARC nations, availability and dissemination of data and information is scarce. Therefore the implications and impact of services trade reform is barely understood in South Asia. As services account for an important share of the South Asian economy, it has become increasingly important to liberalize services trade. Liberalization in services would enhance both access and efficiency of telecommunication, transport and financial services sectors by reducing cost and increasing quality and therefore could improve the overall economic performance. Social services like healthcare and education could also affect the human development of the region.

The SAARC region has already started reforms in service sectors by making commitments and taking different initiatives under multilateral framework i.e. GATS, under regional framework i.e. BIMSTEC and bilateral agreements i.e. CEPA between India and Sri Lanka. But still trade in services is far behind its proportion to GDP. If included under SAFTA, the reforms process is expected to move further.

Key Issues

- Services reform can adversely affect the LDCs of the SAARC region. It could raise unemployment level, given the fact that factor markets are imperfect. Therefore, there could be a trade off between medium term unemployment and longer term increased competitiveness and policy makers have to decide on this.
- Effective regulation is another critical issue for services as unlike the goods sector services cannot be inspected before consumption. The SAARC region has been historically characterized by over-regulation, while what is required is effective and limited regulation. An effective, simplified and transparent regulatory system is required for liberalization.
- It is also important to highlight data and information issues. Availability and dissemination of data and information regarding various rules, norms and negotiations of services trade is a must for liberalization.
- The growth in services has been in areas of low employment elasticity such as IT and IT Enabled Services, travel, tourism, financial services, communication, and

not in healthcare, education, transportation, and construction with higher elasticity.

There is an urgency to make services growth more inclusive by identifying services that can generate greater trade and employment. The increased trade in services matching the output growth in services would facilitate a faster sustainable and equitable growth rate for the region. There is a tremendous scope for developing efficient service sectors in the region through an open exchange of ideas and sharing of experiences among the SAARC members.

Building the Climate for Investment/Business

Investment climate is crucial for a region's prosperity and growth. High bureaucratic and corrupted institutional arrangements, high regulation on finance and financial services and unreliable access of infrastructure result in weak investment climate in South Asia and thus the returns on potential investments become low and uncertain. This will certainly hamper the growth prospect of the region. On the other hand, good governance and better investment climate accumulate investment and therefore bring higher growth for every sector. The expected rate of return of an investment/business is determined by broader business environment along with the degree of efficiency on the factory floor. The costs associated with weak investment climate can more than offset technical efficiency gain. Therefore, the SAARC nations need to reform the investment climate indicators to provide better investment and business environment for the region.

Initiatives needed to reform the investment climate in South Asia:

- South Asia's energy shortages can be served through regional cooperation and integrated energy network of power and gas lines throughout the region.
- Transport cooperation is also needed in the form of an integrated transport infrastructure to permit uninterrupted travel to and from the main trading centers (eg. Peshawar to Chittagong, Kathmandu to Colombo etc) within the region and also connecting the neighbouring regions - Central Asia, the Persian Gulf, South East Asia.

- Cooperation in investment through vertically and horizontally integrated production systems is also necessary. To ease and integrate the business activities, all financial transactions could be performed through a South Asia Development Bank.
- A well functioning financial sector encourages investment activities of any region.
- An integrated business network should be set up to share information, experiences and undertake an action programme in the policy areas of strengthening the investment climate.
- Greater involvement of private sector to play a full role in economic growth and create a competitive environment, implement a transparent and balanced regulatory regime and zero tolerance of corruption is necessary.
- To reform the investment climate in South Asian countries, a prerequisite is reduction in political and state involvement in investment and business activities

A greater voice for the private sector

Private sector participation is vital to mitigate challenges and constraints that SAARC countries confront in trade, finance and investment. It is also important for successful regional integration in the SAARC region. Private sector involvement helps harness the vast and diverse potential of SAARC nations and transform and integrate them for economic gains. Finally, private sector could provide the impetus for greater government-led cooperation initiatives for the region on various economic fronts.

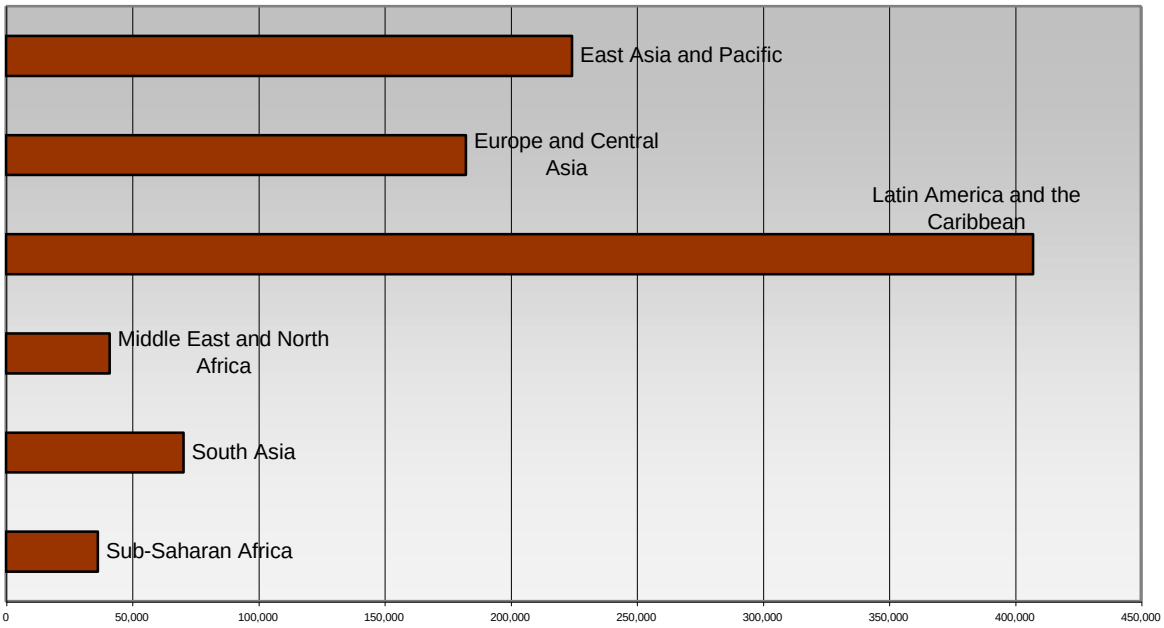
There is need for extensive modernisation of infrastructure, logistics and customs as well as creating additional facilities. Without massive investment from the private sector, there is little hope of adequate development. The governments on their part should continue to take measures to provide an enabling environment for facilitating the private sector. Through emphasizing the need for Public Private Partnership (PPP), SAARC countries can improve investment environment; can have access to uninterrupted power supply at competitive rates, good quality road, rail and telecommunication network,

efficient port operations, and quick custom clearance at the ports which in turn are vital for regional integration and sustaining growth momentum.

Economic integration begins as a natural process of business integration. Currently, some initiatives to promote greater private sector involvement and business cooperation have been undertaken in SAARC region – e.g. South Asia Sub-regional Economic Cooperation (SASEC) Program organized by Asian Development Bank and South Asia Business Forum.

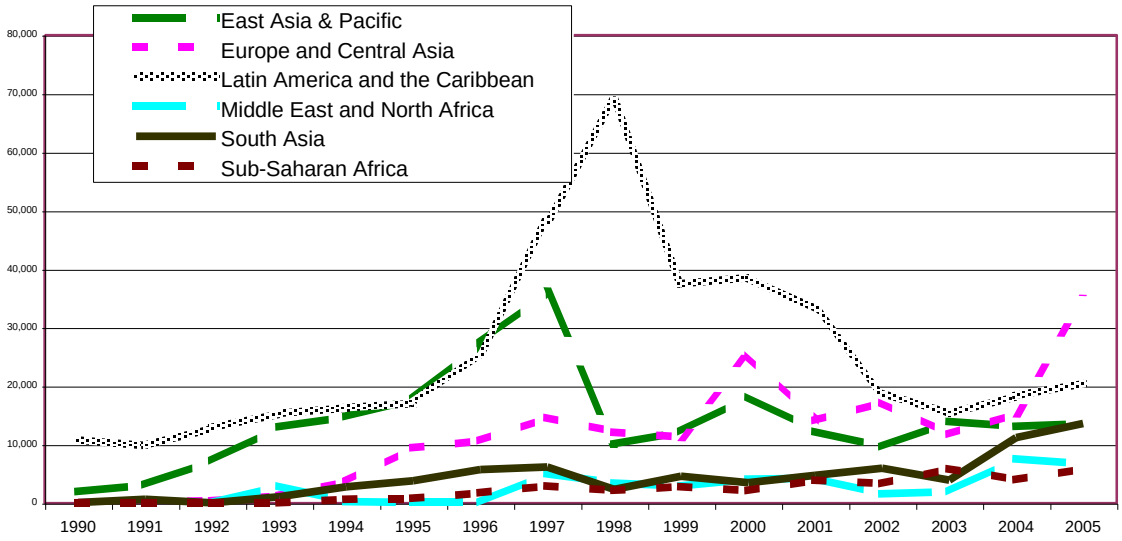
Encouraging private sector investment is an important aspect of development policy in the entire region. However, actual private investment has been very limited and far from adequate so far, mainly due to lack of appropriate policy, procedural hurdles and lack of adequate domestic enterprises. Further, the governments of the region will need to do a lot to encourage investments by the private sector and facilitate healthy competition.

Figure 7.2: South Asia lags far behind the leaders: Region-wise investment in projects by private participation 1990-2005 (US$ million)



Source: World Bank and PPIAF, Private Participation in Infrastructure (PPI) Project Database.

Figure 7.3: Annual Investment with private participation 1990-2005 (US$ millions)



Source: World Bank and PPIAF, Private Participation in Infrastructure (PPI) Project Database.

But investment trends in South Asia are steady and rising. South Asia also has to look at the Public-Private Partnership (PPP) model for some public utilities like water supply, electricity, etc. But a good regulatory framework is a prerequisite for this.

CHAPTER 8

AREAS OF COOPERATION AMONG SAARC COUNTRIES AND RECOMMENDATIONS

This chapter lists the key areas of cooperation that need focus and makes recommendations for successful and broader regional integration in the SAARC region. The recommendations are taken from the SAARC overview paper prepared for discussions for the CEO's Roundtable at the SAARC Summit 2007.

Trade

- Propose completion of SAFTA at the earliest.
- Further tariff rationalization is needed in all SAARC member countries to bring down the tariffs to ASEAN levels.
- India being the country with an excellent track record of growth and 80 percent of South Asia GDP, needs to propose zero tariff regime with respect to SAARC and also an appropriate RoO regime to pre-empt any misuse of elimination of tariff. This may set an example for other countries to follow.
- Easier market access and special preferences should be given to Least Developed SAARC Countries such as Bhutan, Maldives and Nepal.
- Need a committee to harmonize trade related regulations and India can offer expertise on the institutional building aspects.

Infrastructure

- Need greater and efficient implementation of transport linkages (more flights and air cargo facilities, improved passenger air services, expansion of shipping links, and better physical connectivity through rail and road) among South Asian economies to generate huge benefits and expedite the trading process by increasing flow of goods and services.
- India’s region specific linkages with South Asia need to be given special attention and public–private involvement are needed significantly to promote efficient and safe connectivity and border institutions.
- Container train operations on major freight corridors are needed to provide an efficient and competitive service while at the same time alleviating congestion on the road network within the corridor.

Trade Facilitation

- Need to address regulatory environment, standards harmonization etc in a time bound manner.
- Need cooperation/harmonization in customs related matters; green channel treatment of imports, and selective Pre-Shipment Inspection (PSI) facilities from other South Asian countries—reliance on self-declaration and risk management systems.
- Need to improve coordination between SAARC countries and efficient port facilities to ease movement of goods and services across borders.
- Improve exchange of information on market and legal environment—information on standards; import rules; investment opportunities; and opening of trade body offices in SAARC member countries.
- Need to establish an export-import inspection system in tandem with internationally accepted good regulatory practices. Cooperation between quality inspection organizations among the SAARC member countries is also needed.
- Introducing Mutual Recognition Agreements on Standards as a signal towards removal of all non-tariff barriers with each other.
- Increasing reliance on computers and modern communication to facilitate the processing of cargo information and reduce the discretion granted to individual customs personnel.
- Need 'single window' operations to provide a one-stop shop solution to the trader to fulfill all export, import and transit related regulatory requirements – thus reducing turnaround time and labor costs. In some cases joint border facilities are also needed to improve border post performance in terms of enhanced services and the more effective use of border facilities.
- Mutual agreement on holding of trade exhibitions in SAARC region.

Services

- Need to make services growth more inclusive by identifying services that can generate greater trade and employment such as education, healthcare, transport, and construction.
- Along with IT and BPO, other sectors such as healthcare, education, financial services, tourism, and entertainment need to be gradually exposed to outside demand and competition and to promote greater intra-regional trade.
- India's experiences of private sector participation in social services should be shared with other South Asian countries. Corporate funded rural and welfare schemes can also be shared with other SAARC countries.
- Cooperation in the Banking sector institutions, especially related to trade and investment is also needed between all SAARC member countries.
- South Asian policy makers and trade negotiators need to be fully informed about both the opportunities for expanding trade in services, unilaterally, regionally, multilaterally, and the domestic pre-conditions for successful services liberalization.

Investment

- For market efficiency, technology transfer and business sophistication to spread, Indian companies should be allowed to invest in South Asia with the least amount of interference. Similar provisions should be provided to other member countries.
- Need promotion of trade and investment linked banking agreements between SAARC member countries.
- Each SAARC member should improve its performance indicators outlined in the World Bank's Doing Business Report to facilitate greater flow of FDI.

Tourism

- Opening of tourist offices and exchange of information between tourism bodies.
- Need collaboration between tourism ministries and agencies of all South Asian countries. The benefit will be more for smaller countries like Bhutan, Nepal and Maldives.
- Need better air links to expand tourism between SAARC countries and other countries.
- Visas for the smaller countries need to be available at the airport on payment of fees.

Agriculture

- Cooperation between agricultural research institutions is needed among all SAARC member countries.
- Cooperation on development of efficient agro-industries is also needed in the region by sharing experiences with each other.
- Joint venture projects need to be undertaken to rapidly accelerate the growth in agriculture.

Energy

- Need to encourage enterprises of SAARC countries to work together to optimally exploit the petroleum and natural gas resources
- Need to cooperate in developing the technologies for renewable resources including wind energy, solar energy, tide energy, bio-energy, etc. The countries can jointly develop the new energy technologies through cooperative projects.
- Cooperation between relevant governmental departments which conduct research, formulate policies and take measures to encourage member countries enterprises to strengthen their investments and cooperation in mining of mineral resources such as iron ore, coal and bauxite.

- Need to share experiences in energy management - should conduct more exchanges and share useful experiences in establishing a more efficient energy management system.

Education

- Indian private investors should be able to access other South Asian markets to provide them with cheap and quality education and therefore helping them in growth in services.
- Private sector participation, public-partnership through schemes like education vouchers that can be redeemed in private schools and decentralization are required.
- Need various exchange programmes - exchange between identified universities on identified subjects, education exchange programmes/workshops in teacher's training, exchange ideas through joint academic conferences in various fields among SAARC member countries.
- Need tie up between identified research institutions in identified fields in the SAARC region.

Healthcare

- Exchange of experiences and information - in delivery of health care and managing key diseases, in traditional medicines, building of hospitals, manufacturing of pharmaceuticals etc
- Need harmonization of healthcare standards in the SAARC region.

Cooperation on WTO

- Enhance coordination and cooperation with all member countries for a successful completion of the Doha Round at the World Trade Organization, which is not only for mutual benefit but also for the broader interest of SAARC countries.

- Need to take joint stand on main issues: agriculture, services, NAMA, and Special & Differential Treatment (S&DT).

Development of SMEs

- Experiences of development of SMEs should be shared, including government policies, management system, laws and regulations.
- The governments should create favorable conditions for the SMEs of the member countries to cooperate with each other; for example, by holding some exhibitions and information briefings for the products of SMEs so as to encourage the enterprises to communicate and cooperate with each other.
- Need co-operation in knowledge-based industries among all member countries.

CHAPTER 9

THE WAY FORWARD

Based on the analysis outlined above it becomes clear that it is necessary to re-invent SAARC's regional agenda in the era of regionalism and globalization. Enhancing dialogue between the countries of South Asia, thus improving mutual understanding, would be a feasible way to foster greater benefit from regionalism, to end the unstable situation and to foster sustainable and equitable growth throughout the region.

SAARC was formed to progress regional cooperation in the economic sector of the South Asia region; it is yet to fully achieve its objectives. But surely, South Asia, as a region, has far more potential than that indicated by its performance. There are tremendous opportunities to expand trade volume and intensify economic cooperation. The rationale for economic cooperation has been strengthened further in the 1990s by the emergence and success of regional trading blocs like the EU and the NAFTA. The growth dynamism in East and Southeast Asia based on effective cooperation provides the necessary impetus and stands as the example for such cooperation in South Asia.

The paper has clearly highlighted the importance of trade facilitation in the regional framework of SAARC. The advantages from incorporating trade facilitation issues into the national policy are also recognized. For successful integration under SAARC, the prerequisite is increase in intra-regional trade, especially trade between Pakistan and India. It is also an established fact that trade precedes politics, so better political cooperation, understanding and mutual trust will build the environment for better integration.

In near future, the instigation of the proposed SAFTA would surely promote South Asian exports both within and outside the region. Under the SAARC agenda, more developed countries like India should ensure fair and reasonable access to their market. For this, the South Asian countries together need to implement the market access commitments and special and differential treatment provisions of the WTO. Freer movements of goods, services, capital and technology within the region, specially if they are financed by local currencies through an appropriate payments clearing union, could help reduce pressures on foreign exchange requirements of South Asian countries. Such regional economic cooperation could also create opportunities for intra-regional import substitution.

In most of the South Asian countries the contribution of the services sectors to the GDP far exceeds the respective contributions from agriculture and industry. In a few countries like India, the GDP contribution of services exceeds the combined contribution of agriculture and industry. However, agriculture remains the predominant sector in terms of providing employment in the region. The South Asian countries should therefore collectively seek increased access to services and agricultural markets in the developed countries and elsewhere on competitive basis. They also need to seek access to reasonably priced technologies and resources for improving the outputs and productivities of the region.

The leaders of the region need to identify the areas of cooperation and also need to develop understanding. But only regional and economic integration is not enough for growth and prosperity in the region. With enormous potential for growth and prospect of being a strong economic and regional bloc in the world, a lot more needs to be done. Along with economic and monetary union, cooperation in the fields of trade, energy, environment, food security and combating terrorism are crucial.

To ease trade, investment and business facilitation, there is a proposal among SAARC nations for making a free economic zone and allowing common currencies throughout the region by the end of 2014. Kashmir could set an example and become a model by allowing both Indian and Pakistani currencies. Similarly some portions of North Bengal have the example of allowing both Indian and Bhutanese currencies.

The New Delhi SAARC Summit on April 2007 can be remembered as an important turning point for SAARC as it shared conviction of SAARC leaders that the time for pious, and occasionally pompous, conflicts was over. For the first time, SAARC was attended by observers from China, Japan, the EU, Republic of Korea, and the United States. Afghanistan became the eighth member of SAARC. It is declared in the 14th SAARC Summit that '…with the welfare of the peoples of South Asia uppermost in SAARC summit agenda, all the SAARC member countries' governments agreed to build a Partnership for Prosperity and work towards shared economic cooperation, regional

prosperity, a better life for the people of South Asia, and equitable distribution of benefits and opportunities of integration among the peoples and the nations'. The main declarations of this summit are establishment of SAARC Development Fund (SDF), SAARC Food Bank (SFB), SAARC Standards Coordination Board and South Asian Universities in India.

In his speech at the closing session of the SAARC Summit 2007 at New Delhi, the chair, Prime Minister of India, Dr. Manmohan Singh, in the light of the exchanges that had taken place among the heads at the retreat, said: "We have agreed to make tangible progress in the next six months on four issues which affect our peoples' daily lives: water (including flood control), energy, food and the environment." Equally significant was the indication that the help of "international agencies" would be sought for developing projects in these four sectors. For the first time, there is a clear sense of urgency. It is imperative that people to people contacts are intensified, and that civil society in South Asia maintains constant pressure on all the governments in the region to accelerate and intensify the process of regional cooperation.

Further, some progress has been made after the SAARC Summit 2007 declarations. Some actions and projects have been undertaken to deliver direct benefits to the SAARC people. The land and area for the South Asian University have been identified. Connecting one or two hospitals in each of the SAARC countries with 3-4 super specialty hospitals in India has also started. India has also started to contribute to SAARC development projects. Some examples are solar rural electrification for 300 houses, water harvesting in Sri Lanka and Bhutan, setting up seed testing laboratories, tele-education, etc. The draft Agreements on Mutual Legal Assistance in Criminal Matters, Motor Vehicles and Trade in Services under SAFTA are being considered and negotiated (Press Information Bureau, GoI, 2008). Recently, the Reserve Bank of India is set to launch retail payment service of Indo-Nepal remittances through National Electronic Funds Transfer (EFT) facility from May, 2008. Subsequently this service would be extended to all other SAARC countries.

Another important feature of SAARC is the significant presence and decisive role of India in the region. India has 63.14 per cent of land area, 79.28 per cent of the GDP, 77.29 per cent of total trade and 74.46 per cent of the population of SAARC as a whole. The region is suffering from disputes and animosity between India and the smaller states.

SAFTA can only be successful in creating a free trade area if bottlenecks in the way are removed. Trade volume cannot be raised without addressing and reducing economic challenges and constraints inhibiting economic integration in South Asia. India's responsibility is much higher in making SAFTA a successful instrument of increasing trade. India is the largest member of SAARC and should offer more concessions and greater market access to smaller SAARC countries on the trade front. Given the economic asymmetry in South Asia and the predominant position of India in the region, India needs to act as an anchor economy to connect South Asia with East Asia to form an Asia-wide free trade arrangement.

India is the best performer in the region, enjoying one of the highest rates of GDP growth in the world, commanding a very respectable position in multilateral discussions. It has to win the confidence of its neighbours, and not be viewed as a threat. This has to be supported by actions to improve trade and investment. For the latter, we need to move on two fronts simultaneously — a regional initiative to improve trade facilitation within South Asia, and India further opening its markets to neighbours without demanding reciprocity. India needs to allow all imports of our neighbours duty-free, with a small negative list. This will increase our trading activities with other members of SAARC, while helping to promote trust towards us that may have a long-run positive impact for the whole region.

Girija Prasad Koirala, Prime Minister of Nepal, said at the 14th SAARC Summit Meeting, 'SAARC process must be geared to free people from the chains of poverty and misery through the efficient, effective and equitable utilization of human and economic potentials. Pervasive poverty, hunger, misery, disease and ignorance are our formidable challenges and this can only be overcome by mutual cooperation…We must make sure that we create and sustain a regional synergy in our efforts, which would contribute to

enhance competitiveness and ensure prosperity to all. In this day and age of global interdependence, enhancement of cooperative efforts will develop a win-win situation for all. We should not lose this opportunity. Let us pledge ourselves to take the SAARC process to a new height with a collective vision, firm commitment and effective implementation of programs on a priority basis.'

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