Integration of Least Developed Countries into South Asian Free Trade Agreement:

A Human Development Perspective

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Foreword

The overriding objective of regional cooperation in South Asia is to assist countries in the region to reduce poverty, promote welfare, and accelerate economic growth, social progress and cultural development. A question often raised in the context of the South Asian Free Trade Agreement (SAFTA) has been of crafting a process of regional integration that addresses the structural asymmetries and varying levels of development in the region. South Asia includes four least developed countries (LDCs): Afghanistan, Bangladesh, Bhutan and Nepal (Maldives graduated from its LDC status in January 2011). These four countries are beset with structural and supply-side constraints that limit their meaningful and beneficial participation in intra-regional trading opportunities.

In line with its mandate of fostering regional cooperation efforts consistent with human development objectives, the Inclusive Growth and Poverty Reduction Team of UNDP's Asia-Pacific Regional Centre is pleased to bring out this report: *Integration of Least Developed Countries into the South Asian Free Trade Agreement: A human development perspective.* The Report seeks to address the outstanding issues and concerns relating to the South Asian regional integration processes. The study finds that the existing provisions relating to special and differential treatment for the LDCs are neither meaningful nor enforceable. A key issue has been the steady erosion of preferences of the LDCs in the Indian economy, which serves as the largest market in the region. This is ascribed to India's participation in extra-regional agreements along with India's recent announcement of unilateral duty-free and quota-free treatment for all LDCs worldwide.

LDCs in the South Asia region continue to be handicapped by structural weaknesses, such as a high level of export concentration, economic vulnerability to external shocks and a variety of supply-side constraints that include inadequate infrastructure, lack of human capital and access to credit, and a virtual absence of trade facilitation measures. Restricted transit facilities, geographical constraints, such as being landlocked, act as barriers to trading opportunities as well.

A number of policy recommendations have been made including a proposal for setting up of an LDC Integration Fund, promoting liberalization of the services sector and fostering and protecting investments. We hope that this report will be useful to the governments, research institutions, civil society and other stakeholders in the South Asian region in shaping the process of regional integration with a human development orientation.

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Abbreviations and acronyms

ADB	Asian Development Bank
AFTA	ASEAN Free Trade Area
APEC	Asia-Pacific Economic Cooperation
ASEAN	Association of Southeast Asian Nations
BIMSTEC	Bay of Bengal Initiative for Multi-Sectoral and Technical Economic Cooperation
BTA	bilateral trade agreement
CAGR	compound annual growth rate
CASAC	Coalition for Action on South Asian Cooperation
CGE	computable general equilibrium
COMESA	Common Market for Eastern and Southern Africa
CU	customs union
DFQF	duty-free and quota-free
DTIS	diagnostic trade integration study
EBA	Everything But Arms (initiative of the European Union)
EU	European Union
FDI	foreign direct investment
FTA	free trade agreement
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GDA	Geographically Discriminatory Arrangement
GDP	gross domestic product
GTAP	Global Trade Analysis Project
HDI	Human Development Index
HS	Harmonized System
ICT	information and communications technology
IF	Integrated Framework for Trade-Related Technical Assistance
IMF	International Monetary Fund
IOR-ARC	Indian Ocean Rim Association for Regional Cooperation

IT	information technology
LDC	least developed country
LDF	local development fee
Mercosur	Southern Cone Common Market
MFA	Multi-Fibre Arrangement
MFN	most-favoured nation
NAFTA	North American Free Trade Agreement/Area
NTB	non-tariff barrier
OECD	Organisation for Economic Co-operation and Development
PTA	preferential trading arrangement
R&D	research and development
RCA	revealed comparative advantage
ROO	rules of origin
RTA	regional trade agreement
S&D	special and differential
SAARC	South Asian Association for Regional Cooperation
SAFAS	SAARC Framework Agreement on Trade in Services
SAPTA	SAARC Preferential Trading Arrangement
SARSO	South Asian Regional Standards Organization
SASEC	South Asia Subregional Economic Cooperation
SAWTEE	South Asia Watch on Trade, Economics and Environment
SEEP	Sustainability, equity, empowerment and productivity
SHRDC	SAARC Human Resources Development Centre
SME	small and medium-sized enterprise
SPS	sanitary and phytosanitary
T&C	textiles and clothing
TBT	technical barrier to trade
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UNESCAP	United Nations Economic and Social Commission for Asia and the Pacific
WTO	World Trade Organization

Executive summary

As one of the least integrated regions in terms of trade and investment, South Asia faces enormous challenges to deriving potential benefits from broader economic cooperation and in addressing human development concerns. These challenges are even more profound for the region's five least developed countries (LDCs),[1] which suffer from several structural weaknesses, have a narrow export base and are unable to take advantage of the limited market access opportunities provided by the South Asian Free Trade Area (SAFTA) due to several supply-side constraints.

The raison d'être of SAFTA is to promote economic development in the region, assist member countries in their efforts to alleviate poverty and, above all, help raise the living conditions of the people. However, SAFTA should not be viewed in isolation; it is part and parcel of a broader regional cooperation arrangement embodied in the Charter of the South Asian Association for Regional Cooperation (SAARC). That charter, *inter alia*, strives "to promote the welfare of the peoples of South Asia and to improve their quality of life" as well as "to accelerate economic growth, social progress and cultural development in the region and to provide all individuals the opportunity to live in dignity and to realise their full potentials" (SAARC, 1985). Therefore, it is clear that human development, defined as a process of expanding people's choices and allowing them to live secure lives with full freedoms and rights,[2] has been embedded in SAARC objectives ever since its inception.

Against this backdrop, this paper attempts to test two main hypotheses. First, despite political rhetoric, the current process of regional trade integration under SAFTA is indifferent, if not inimical, to the needs and conditions of the South Asian LDCs. Second, the modalities and pace of regional trade integration under SAFTA have not taken sufficient account of the human development objectives identified by and included in the SAARC Charter. Left to its own devices, SAFTA is unlikely to contribute to improved human development, particularly in the region's LDCs.

Based on a survey of existing literature, this study takes the position that regional trade agreements (RTAs), although offering only a second-best policy option for trade liberalization, can be potentially beneficial for the participating countries from an economic as well as human development perspective. The study also suggests that RTAs can serve as a building block to multilateral trade liberalization. According to economic theory, South-

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1 These are: Afghanistan, Bangladesh, Bhutan, Maldives and Nepal. At the time of writing, Maldives was about to graduate from LDC status.

2 Human development is a concept that was first defined by Mahbub ul Haq (founder of the *Human Development Report* published annually by the UNDP) as a development paradigm that is "about creating an environment in which people can develop their full potential and lead productive, creative lives in accord with their needs and interests." (see: http://hdr.undp.org/en/humandev/.)
This concept is supported by Nobel laureate Amartya Sen (2000), who suggests that development policies should be directed towards maximizing peoples' capabilities — their ability to live a life they value most.

South trade agreements tend to be more trade diverting than trade creating in nature. However, a number of authors have recently challenged this position on the grounds that the economic theory underpinning the regional integration debate takes into account only static gains or losses and fails to factor in the dynamic gains to be had from a trade and investment nexus, technology transfer and the positive spillover effects of RTAs.

Where RTAs are of the shallow integration variety, covering only trade in goods, gains are normally skewed in favour of the larger trading partners. So far, SAFTA only covers trade in goods and does not fully address the issues of para-tariff measures and non-tariff barriers (NTBs). Moreover, it allows members to pursue protectionist policies through the use of sensitive lists, and it does not provide for meaningful and enforceable special and differential treatment for the LDC members. Therefore, the benefits from SAFTA are likely to be limited at best. There is a general consensus among academics and policy makers that if other areas of cooperation are not explored, the prospects for trade and economic growth in the South Asian LDCs are not promising.

An assessment of SAFTA from the LDCs' perspective reveals that their inability to penetrate the largest market of the region — India — is a major problem for these weak and vulnerable economies. This is mainly ascribed to the lack of predictability of market access in India, which not only imposes several para-tariff measures and NTBs, but also introduces new barriers whenever under pressure from domestic vested interests. The problem is further compounded by the fact that India has either entered into or is in the process of entering into various transregional trading arrangements, such as the India-Singapore Comprehensive Economic Partnership Agreement, the India-Association of Southeast Asian Nations (ASEAN) Free Trade Agreement (AFTA) and the European Union-India FTA. These are likely to result in an erosion of preferences for the LDCs, which currently enjoy a certain amount of preferential market access in India. Moreover, India has unilaterally provided duty-free and quota-free (DFQF) treatment to all the LDCs in the world. Although the magnitude of those concessions is limited to 94 percent of India's tariff lines, this could further erode preferences for the LDCs in the region (Adhikari, Yamamoto and Dourng, 2008).

An analysis of various problems faced by the LDCs in their attempts to better integrate into the regional economic mainstream shows that the LDCs are handicapped by their own structural constraints, such as a high level of export concentration and thus economic vulnerability to external shocks; geographic constraints, such as landlockedness (Afghanistan, Bhutan and Nepal) and remoteness (Maldives); and supply-side constraints, such as inadequate infrastructure, lack of human capital, limited access to credit and the virtual absence of trade facilitation measures. Landlocked LDCs face several barriers to transit because of their high dependence on their transit neighbour's infrastructure, peace and stability, and administrative practices. To secure the right to free and unfettered transit, a landlocked country needs to maintain amicable political relations with its transit neighbour – a condition often lacking in South Asia.[3]

South Asian LDCs' potential to benefit from regional trade is further impaded by the prevalence of informal trade (which deprives them of much-needed additional revenue) and weak governance. Finally, the numerous bilateral trade agreements not only tax the negotiating capital of the LDCs but also create confusion due to overlapping rules. They also increase the vulnerability of the LDCs due to their limited negotiating prowess, thus further stymying the LDCs' abilities to take advantage of SAFTA (Adhikari, 2009a).

Based on a conceptual framework for public goods developed by Kaul and Mendoza (2003), this paper argues that SAFTA, as it currently stands, does not fit into the framework of a "regional public good", which should be the main purpose of a regional integration arrangement of this nature. An analysis of the real and perceived benefits of the various regional and subregional initiatives aimed at better integrating South Asian LDCs reveals that these initiatives fall far short of this objective. The problem is further exacerbated by a lack of political will and severe resource constraints, which limit the ability of these initiatives to enhance LDCs' integration within SAFTA.

The analysis of the trade and human development nexus within the region in general, and in the context of the LDCs in particular, makes it abundantly clear that SAFTA, in its current form, does not promote human development, particularly in the LDCs. It could do so if the regional integration programme was appropriately designed and the domestic systems of governance overhauled to ensure that both contribute to promoting equity, empowerment, productivity and sustainability and to ensuring that people become the true beneficiaries of regional integration. These are necessary conditions for achieving the goal enshrined in the SAARC Charter, which should be the touchstone for evaluating the success, or otherwise, of SAFTA. Regional integration alone does not ensure better human development outcomes, not least because it is the responsibility of the individual countries to design the necessary flanking policies that contribute to poverty reduction and human development objectives.

This seemingly depressing picture need not remain so, provided serious thought is given to harnessing the potential of SAFTA, or a broader regional economic cooperation arrangement, for the benefit of the LDCs in general and for furthering their human development objectives in particular. Efforts are required on three fronts: removing market access barriers, overcoming supply-side constraints and expanding the remit of SAFTA.

The provision of better market access should involve, as a priority, a reduction in the size of the sensitive lists of the developing countries in the region and the removal of para-tariff barriers and NTBs to products of export interest to the LDCs. Similarly, regional cooperation on infrastructure development, in particular transport and energy, development of human capital, provision of efficient transit facilities, improved trade facilitation, and research,

3 Of the three landlocked LDCs in the region, for transit purposes Bhutan has a greater advantage than Afghanistan and Nepal due to its "extraordinarily warm relations" (Choden, 2004: 121).

development and innovation, which have not figured prominently in the regional economic cooperation discourse in South Asia thus far, will go a long way towards realizing the true potential of SAFTA. For this, the study recommends that a relatively large-sized LDC Integration Fund be created. Finally, given the limited comparative advantage of the South Asian LDCs in the goods sector, coupled with the lack of a trade and investment nexus, two major areas for expanding the remit of SAFTA are the liberalization of services and protection and promotion of investment. Although the SAARC Framework Agreement on Trade in Services was signed prior to the 16th SAARC Summit in Thimpu, Bhutan on 28–29 April 2010 (and this should be considered a welcomed development) negotiations on schedules of commitments are yet to begin. Given the mercantilist predilection[4] of South Asian trade negotiators, any agreement schedules of commitments that not only increase trade in services within the region but also leverage such trade for achieving human development objectives is likely to prove contentious. However, the issues of investment protection and promotion and intraregional flows of investment, which could potentially result in tremendous benefits for the LDCs, have not yet received the attention they deserve within SAARC.

4 The fact that trade negotiators are guided by a mercantilist instinct is best elaborated by Nobel laureate Paul Krugman (1997) in his terse analysis normatively titled, "What Should Trade Negotiators Negotiate About?" According to him, negotiators get a sense of achievement not only by obtaining market access in their partner countries but also by closing market access to their own country's market. For the prevalence of this phenomenon in the context of SAFTA negotiations, see chapter III, section 4 of this paper.

Chapter 1

Introduction

1.1 Background

South Asian countries are relative latecomers to regionalism and, consequently, among the least regionally integrated countries, though their current pace of integration into the global economy is probably the most rapid in their history. The officially recorded value of intraregional merchandise trade in South Asia constitutes about 5 percent of the region's total foreign trade (IMF, 2010), as compared with 25 percent for the Association of Southeast Asian Nations (ASEAN) (WTO, 2008a:3). So far, the implementation of SAFTA since July 2006 has not resulted in a significant increase in the share of intraregional trade.[5] In the LDCs of the region, while intraregional imports have been growing rapidly, exports to regional trading partners have been dwindling (Adhikari, 2010). This may be ascribed to, among others, the elaborate sensitive lists of member countries and the existence of non- and para-tariff barriers, including complicated rules of origin (ROO).

Theoretical arguments in favour of North-South regional trade agreements (RTAs) as opposed to South-South RTAs are justified, particularly because high most-favoured-nation (MFN) tariffs on products of trading partners outside an RTA can lead to trade diversion. Many studies have also found that any gains from South-South RTAs accrue mostly to the relatively advanced countries within the RTAs (see, for example, Schiff and Winters, 2003; World Bank, 2000; Ben-David, 1993, 1996). Although some of the empirical findings support this theoretical premise, other studies support rather different findings, arguing instead that South-South RTAs are trade creating (see, for example, Nanda, 2008; Cernat, 2003).

Some studies (e.g. Weerakoon and Thennankoon, 2006) have criticized the way in which supposedly empirical findings are derived by using various quantitative analyses, including the gravity model, the computable general equilibrium (CGE) model and the Global Trade Analysis Project (GTAP) model. A careful analysis of the results derived so far leads to the conclusion that the empirical evidence on the benefits of South-South RTAs is inconclusive at best. Various empirical studies that have been conducted over the past 15 years analysing the potential benefits of a preferential trading arrangement (PTA) and/or a free trade agreement (FTA) within South Asia are also clearly divided, not only concerning the benefits but also whether or not there are likely to be asymmetric benefits favouring some members at the expense of others. It is natural that the gains from trade are unlikely to

5 This does not mean that the volume of intraregional trade has not been growing. On the contrary, according to the latest data available from the *Direction of Trade Statistics* of the International Monetary Fund (IMF), between 2000 and 2008, intraregional trade in South Asia grew by 387 percent (from $6.2 billion to $30.4 billion). However, since the growth in extraregional trade has far outstripped the growth in intraregional trade, the share of intraregional trade in the region's total trade remains low.

be shared equally by all the partner countries of an RTA, SAFTA being no exception. The asymmetric benefits within any RTA result from the large variations in size of the economies of the member countries, their economic structures, their institutional endowments, the policy intervention mechanisms they have in place, their productive capacity and efficiency of their enterprises (Razzaque, 2007; Adhikari, 2010).

Despite such empirical ambiguity, many South Asian policy makers continue to believe that deeper regional trade integration can create spillover benefits and that it is essential for strengthening ties between the member countries (Weerakoon and Thennakoon, 2006). This is bolstered by the idea that the traditional concept of trade creation and trade diversion should be considered along with the role regional trade can play in promoting intraregional flows of investment as well as transfer of knowledge, skills and technology (Kelegama and Adhikari, 2007; RIS, 2004).

Although intraregional trade in South Asia amounts to more than US$30 billion, the LDCs of the region have benefitted very little from that trade, particularly in terms of their exports. This situation is unlikely to change unless radical reforms take place within SAFTA. According to a GTAP simulation by Raihan and Razzaque (2007), a complete removal of tariff barriers within SAFTA would lead to net losses for the LDCs, particularly Bangladesh. Most of these losses would be due to trade diversion and terms-of-trade shocks. However, because this study assumes the complete elimination of tariff barriers on goods as the only criterion to judge the utility of SAFTA, the results should be interpreted with caution.

The chequered history of the SAARC Preferential Trading Arrangement (SAPTA) – the predecessor of SAFTA, which made little contribution to enhancing regional trade – as well as the ambivalence of trade officials concerning the utility of regional trade integration are also cause for concern. Many of those officials believe that SAFTA may not be as useful as was envisaged by the Eminent Persons Group that was constituted by SAARC in 1999 for charting out the course of regional integration in South Asia. This view is reinforced by the long sensitive lists maintained by member countries (as noted), the presence of para-tariff and non-tariff barriers, rigid and cumbersome ROO, overlapping bilateral trade agreements and continued animosity between the two largest economies of the region – India and Pakistan.

Given that the LDCs of the region will be net losers if the status quo is maintained, SAFTA has incorporated several special and differential (S&D) provisions for these countries. They include a longer transition period to implement their liberalization commitments, accelerated liberalization of sectors of interest to them, leeway to maintain a longer sensitive list, favourable ROO, revenue compensation for losses arising from trade liberalization, and technical assistance and capacity-building. However, most of these are 'best endeavour' commitments and lack enforceability (Adhikari, 2004a). Moreover, there are several other impediments to promoting regional trade, particularly from the perspective of the LDCs, including structural and institutional constraints, supply-side constraints and geographical constraints. These practical issues are eschewed in discussions about SAFTA or even within SAARC.

Finally, it has been argued by several commentators that the real benefit of SAFTA, particularly for the LDCs, lies in liberalization of services and investment (Zaman, 2008; Sawhney and Kumar, 2008; Bhatt, 2006). But the slow progress in negotiations on services, coupled with the apathy of trade officials to include the investment issue on the agenda in discussions on SAFTA, has raised serious concerns among the LDCs about the potential of SAFTA to provide any meaningful benefits to their economies.

1.2 Human development context

South Asia is the region with the largest concentration of poverty. The human development indicators for South Asian countries are higher than those for most sub-Saharan African countries but much lower than those for many developing countries with comparable per capita incomes. According to UNDP (2009), of the eight countries in the region, seven were in the category of countries with a medium human development index (HDI) and their rankings, out of 182 countries, were: Maldives (95), Sri Lanka (102), Bhutan (132), India (134), Pakistan (141), Nepal (144) and Bangladesh (146). Afghanistan is the only country in the region with a low HDI (181). These poor rankings notwithstanding, a comparison of the HDIs of the five countries in the region, for which data are available since 1975, shows that they have consistently improved their performance. For example, Sri Lanka improved its HDI performance from 0.619 in 1975 to 0.759 in 2007, and Bangladesh improved its HDI performance from 0.301 to 0.543 over the same period (UNDP, 2007: 172-173).

SAFTA aims to promote economic development in the region, create an environment for helping its member countries tackle poverty alleviation and, above all, raise the living conditions of their people. SAFTA should not be viewed in isolation but rather as part of a broader regional cooperation arrangement, as provided for in the SAARC Charter. That charter strives, "to promote the welfare of the peoples of South Asia and to improve their quality of life" as well as "to accelerate economic growth, social progress and cultural development in the region and to provide all individuals the opportunity to live in dignity and to realise their full potentials" (SAARC, 1985). Therefore, it is clear that human development, defined as a process of expanding people's choices and allowing them to live secure lives with full freedom and rights, has been embedded in SAARC ever since its inception.

Although the link between trade and human development is neither automatic nor clear-cut, the relationship between these two forces is mediated through economic growth. The experience of Asian countries in general demonstrates that trade liberalization can facilitate a two-way virtuous relationship between human development and economic growth. However, for South Asia to replicate this model, strategic economic integration is needed. This presupposes, among others, the ability of the countries to preserve the policy space necessary for achieving their human development objectives as well as the enforcement of mechanisms to ensure that the LDCs are "accorded special and differential treatment commensurate with their development needs" as provided for in the SAFTA preamble

(SAARC, 2004). As discussed earlier, the present provisions of SAFTA and developments to date suggest that these provisions have been nothing more than 'best endeavour' clauses.

Even if serious efforts are made to level the playing field for South Asian LDCs, severe capacity constraints prevent them from deriving the benefits that SAFTA offers. While some of the constraints relate to the underprovisioning of public goods due to limited resources as well as governance failures at the domestic level, others are regional in nature. Therefore, there is a need to probe deeper into the nature and magnitude of the constraints facing the LDCs in order to create an environment conducive to their meaningful participation in the SAFTA implementation processes and their outcomes.

This does not absolve the LDC governments from discharging their responsibilities. It is equally important for them to provide adequate public goods in order to, *inter alia,* enable business enterprises to take advantage of market access opportunities available under the arrangement, develop strong human capabilities for enhancing productivity and enable those who lose their livelihoods because of trade liberalization to adjust to the changing environment. The last goal calls for safety nets, alternative employment opportunities and retraining facilities, all of which are generally underprovided in the LDCs (see also UNDP, 2006: 25).

1.3 Justification for the study

A number of studies have analysed the potential implications of SAFTA and have provided some policy recommendations on how to make SAFTA a powerful mechanism for regional integration (see, for example, Rahman, Shadat and Das, 2006; Kelegama and Adhikari, 2007; Sawhney and Kumar, 2008; ADB/UNCTAD, 2008). One study has focused exclusively on the impact of SAFTA on the weaker economies of the region and has proposed some measures to help this group of countries benefit from SAFTA (Razzaque, 2008a). However, none of these studies have: a) focused exclusively on the LDCs and analysed the constraints that prevent their successful integration into the regional economic mainstream; and b) analysed the human development implications of the current pattern of regional economic integration, particularly for the LDCs.

This study aims to fill these two gaps. The study developed two fundamental hypotheses and tested them based on available facts and figures. First, despite the political rhetoric, the current process of regional trade integration under SAFTA is indifferent, if not inimical, to the conditions and needs of its LDC members. If corrective measures are not taken, these LDCs are likely to be further marginalized in the RTA. Second, the modalities and pace of regional trade integration under SAFTA do not sufficiently take into account the human development objectives of the SAARC Charter. SAFTA on its own cannot contribute to improving human development, particularly in the LDCs of the region.

1.4 Organization of the study

This study is divided into eight chapters. Chapter II reviews some of the major existing literature on the costs and benefits of various RTAs, particularly South-South RTAs, with a special focus on the South Asian LDCs. Chapter III sets out the trade policy context for the South Asian countries and assesses the progress made in regional trade integration. A special focus of this chapter is on the implications of SAFTA for LDC participation in the system. Identifying impediments to the effective participation of South Asian LDCs in SAFTA implementation processes and outcomes is the focus of chapter 4, while chapter 5 presents a critical assessment of the efforts made so far, including various regional and subregional initiatives, for better integrating the LDCs into SAFTA. Chapter VI discusses the potential role of SAFTA in promoting human development objectives, particularly for the benefit of the LDCs of the region. Chapter 7 offers some specific recommendations on a possible agenda for action for ensuring a meaningful participation of the LDCs in SAFTA processes and outcomes as well as for helping the LDCs achieve their human development objectives through enhanced and inclusive regional trade. Chapter 8 concludes.

Chapter 2

Review of the literature

2.1 Background

Among the three major variants of what used to be known as geographically discriminatory arrangements (GDAs) among sovereign States, namely customs unions (CUs), bilateral trade agreements and imperial preferences, the first one can be traced back to the seventeenth century, when a CU was proposed among the provinces of France. Following this, Austria signed bilateral FTAs with five of its neighbours in the eighteenth and nineteenth centuries. The first transcontinental trade agreement in the form of a Treaty of Friendship, Commerce and Navigation was signed between the United States and France in 1778 (Pomfret, 2002:18). Later, when Britain was promoting free trade globally during the period of its hegemonic ascendency, it made use of "imperial preferences" as a means of enticing its colonies and dominions to engage in trade with itself as well as to maintain its political clout with these entities.

The prevalence of imperial preferences as well as various forms of PTAs in the years prior to the signing of the General Agreement on Tariffs and Trade (GATT) in 1947 led to considerable debate between the proponents of such a trade policy (United Kingdom) and those sceptical of such an arrangement (the United States) at the time of drafting the GATT. Finally, due to the United Kingdom's strong stance on this issue, the United States agreed not only to grandfather[6] imperial preferences in the GATT but also to have a major exception to the MFN principle included in the treaty in the form of Article XXIV.[7]

A number of integration arrangements were formed during the 1950s and 1960s — a period sometimes referred to as the era of 'old regionalism' (Ethier, 1998: 1149) — but most of them either did not survive or became dormant. However, the European Economic Community (EEC), established in 1957 by the Treaty of Rome, has not only survived but also considerably deepened and broadened its coverage. Started initially with six countries, it was later renamed the European Union (EU) and is now the largest regional grouping in the world, with 27 members. It is also the only grouping that has achieved close to full integration.

Several authors, including Adam Smith, had written about the costs and benefits of GDAs, including PTAs, RTAs, FTAs and CUs. It was Jacob Viner (1950) who provided a powerful tool

6 In public international law, the new treaties and provisions of the treaties normally prevail over the previous treaties, norms or practices. In some exceptional circumstances, some provisions of the old treaty, norms or practices are carried forward, despite their being somewhat incompatible with the new treaties or their provisions. This process is known in public international law as 'grandfathering'.

7 Article XXIV of the GATT titled 'Customs Union' deals with the legal bases, processes and requirements of the regional economic integration arrangements, such as preferential trade agreement, free trade agreement and customs unions (see WTO,1999).

to analyse the costs and benefits of these arrangements, particularly CUs. By labelling GDAs as second-best instruments for trade liberalization, Viner's theory on customs unions took 'trade creation' and 'trade diversion' effects of any GDA as the touchstone for evaluating its net benefits. Trade creation occurs when a reduction of preferential tariffs leads to the replacement of high-cost domestic products by imports from partner countries within the trade arrangement. Trade diversion takes place when a reduction of tariffs on imports from partner countries leads to the displacement of products hitherto supplied by the lowest-cost supplier simply because that supplier happens to fall outside the trade arrangement. Although Viner did not pass judgement on the beneficial or harmful effects of CUs, suggesting instead that these arrangements should be considered on a case-by-case basis, his preference for multilateral, non-discriminatory tariff reductions was clearly reflected in his analysis.

A number of authors subscribed to Viner's insight, which is proof of the rapid acceptance and subsequent generalization of his theory and a basis for the criticism of GATT Article XXIV (see Pomfret, 2002: 180). However, an obvious limitation of Viner's theory was its sole focus on the static effects of integration (i.e. the short-term trade effects resulting from the removal of trade barriers within a particular region). Viner did not look at the dynamic effects of trade liberalization nor did he explore the possibility of firms adapting to the conditions resulting from changes in demand and supply (Andreosso-O'Callaghan, 2005: 55).

This led to the emergence of new ideas that began to challenge the traditional CU theory, with the major intellectual spur provided by a 'new trade theory' based on models of imperfect competition. A second influence came from the formation of the single market by the EU in 1992 and the establishment of the North American Free Trade Agreement (NAFTA) in 1994 (Pomfret, 2002: 207). These arrangements, which are considered part of the 'new regionalism', not only liberalized 'substantially all the trade' within the meaning of GATT Article XXIV but also went beyond the removal of tariff barriers. They are clearly GATT-plus in nature, focus on broader and deeper integration (including the removal of NTBs and restrictions on trade in services and investment) and cover a fairly broad range of areas, from competition policy and labour and environmental standards to the harmonization of regulatory standards.[8]

Regional groupings in Europe are considered pioneers in the growing trend towards regionalism, followed by those in Africa and Latin America, while those in North America and Asia – particularly the latter – are seen as latecomers. The United States began considering RTAs only in the 1980s with the start of talks for the formation of NAFTA, and in Asia, the only serious regional arrangement is ASEAN, established initially as a political platform rather than an economic one. The North-East Asian countries of China, Japan and the Republic of Korea joined the trend towards regionalism much later. In the era of the new regionalism, these Asian countries, considered adherents of multilateralism, have also joined the regionalism frenzy that has gripped the world. Similarly, all the countries of South-East

8 See Ethier (1998) for a detailed economic analysis of the 'new regionalism'.

Asia as well as South Asia are now members of some RTA or PTA. As noted by Sally (2008: 123), "Now that Asia is playing catch-up, with PTA initiatives spreading like wildfire in the past six years", there has been a massive surge in the number of RTAs, especially since the early 1990s. Some 462 RTAs were notified to the GATT/WTO by February 2010, of which 271 agreements were in force.[9] Some argue that this is due to the slowness of the multilateral process in liberalizing trade, but others disagree, stating that there is no empirical evidence to support this contention (Nanda, 2008). Yet others are of the opinion that it is multilateral trade liberalization that has contributed to the growth of regionalism (Ethier, 1998).

As far as the reach of the RTAs is concerned, the integration process is not confined to a particular geographic area; it has moved beyond the regional level to include transregional trading arrangements. These new integration projects, which could have a potentially significant impact on global trade and investment, have been proliferating of late (Cernat, 2003: 3). Three examples are particularly noteworthy. First, the EU, which was initially confined to Western Europe, has now moved eastwards, encompassing, among others, several transition economies. Second, the Asia-Pacific Economic Cooperation (APEC) forum, which aims to develop into a more global arrangement than any other of its kind, encompassing countries as diverse as Canada, China, Japan, the Russian Federation and the United States, is an example of a transcontinental RTA. Finally, NAFTA seems poised to expand southwards as well as reach out to the Caribbean island countries, to form a gigantic Free Trade Area of Americas. Although the latter two arrangements are not progressing as rapidly as the former, they have a considerable symbolic value. Similarly, bilateral trade agreements (BTAs) are assuming transregional proportions, with, for example, the United States signing FTAs with such diverse countries as Singapore and Morocco, and Chile signing FTAs with Australia and the Republic of Korea.

2.2 Economic analysis of RTAs

Contemporary economic analyses of RTAs fail to take into account several new dynamics, though Viner's theory is invoked time and again. With the growing number of RTAs, opinions differ among trade economists as to whether RTAs are "building blocks" or "stumbling blocks" (in the words of Bhagwati (1999)), to multilateral trade liberalization, though they tend to be virtually unanimous that global trade liberalization is the ultimate objective because it tends to be welfare-enhancing. While a thorough review of the literature outlining the various positions in the ongoing debate as well as some relatively more nuanced views can be found elsewhere (see Kelegama and Adhikari, 2007), this section provides a brief summary of the arguments.

Among the proponents of RTAs, Larry Summers (1991) propounded the view that any 'ism' (unilateralism, regionalism or multilateralism) is good as long as it facilitates trade liberalization overall. Bergsten (1997) supported 'open regionalism', which implies

9 Of the total RTAs notified to the WTO, 345 were notified under Article XXIV of the GATT 1947 or the GATT 1994, 31 under the Enabling Clause and 86 under Article V of the General Agreement on Trade in Services (GATS) (WTO, 2010).

liberalization of trade within an RTA while keeping the option open for trade to flow in and out of the arrangement as freely as possible. He contended that an RTA could be used as a device through which regionalism could be employed to accelerate progress towards global trade liberalization and rule-making, and he viewed APEC as a model of 'open regionalism'.[10]

A major analytical contribution to the concept of 'open regionalism' was provided by Baldwin (2000), who argued that the expansion of RTAs was due to the 'domino effect', whereby countries outside the RTAs, which felt worse off after the formation of the RTAs by other countries, would have a strong incentive to join the club. He cited the examples of the EU and NAFTA to explain his theory. He also predicted in 2001 that the domino effect would assume even greater significance in Asia in the future,[11] which is borne out by developments in the previous decade, as previously noted (see Sally, 2008: 123). Later, an empirical study by Sapir (2001: 386) found that the 'domino effect' played a major role in the expansion of the EU.

The domino theory is in part influenced by the 'hub and spoke' theory developed by Wonnacott (1990), which is yet another major theoretical contribution to the regionalism debate. This theory was developed when the United States was about to enter into an FTA with Mexico. Because Canada already had an FTA with the United States, the former felt that in entering into an FTA with Mexico, the United States would become the hub with Canada and Mexico operating as spokes, which would make Canada worse off. Baldwin (2000) believed that it was to prevent this situation that Canada proposed a regional FTA encompassing all three countries in North America, thereby giving birth to NAFTA. The current wave of intraregional FTAs in South Asia, with India assuming the role of the hub and the other countries in the region vying to sign FTAs with India acting as spokes, is reminiscent of the pattern mentioned above.

The opposing camp, which views RTAs as stumbling blocks to multilateral trade liberalization, has been led by Jagdish Bhagwati (1995). He likened the overlapping RTAs and the rules governing such arrangements to a 'spaghetti bowl' and considered the revival of regionalism as an unfortunate development. Expanding on these arguments, Panagariya (1999) argued that due to their high visibility and resultant possibility to energize and unify protectionist lobbies as well as drain the negotiating capital, particularly in poorly endowed countries, RTAs tended to be more damaging to multilateral trade liberalization. Together with Srinivasan (1997), he criticized the idea of 'open regionalism' as an oxymoron. The practical problems of this concept have been highlighted by the current status of APEC and the Indian Ocean Rim Association for Regional Cooperation (IOR-ARC), where progress has been far from satisfactory (Kelegama, 2002).

10 Bergsten was Chair of the Eminent Persons Group of APEC (See Kelegama and Adhikari, 2002).

11 Based on a personal conversation with the author on 22 January 2002 at the World Trade Institute, Bern (Kelegama and Adhikari, 2002; 2007).

According to other, more nuanced views, RTAs can be building blocks to multilateral trade liberalization, and indeed, regionalism and multilateralism can complement each other, provided certain conditions are fulfilled. One of the proponents of this view is Das (2001), who argued that the favourable impact of an RTA is subject to the proviso that it is able to achieve a deeper degree of economic integration than the multilateral trading system. Ethier (1998) was of the view that regionalism, by internalizing an important externality, plays a key role in expanding and preserving the liberal trading order. Together with Hoekman (1995), whose study focused on services liberalization at the regional and multilateral levels among countries belonging to the Organisation for Economic Co-operation and Development (OECD), Either (1998) viewed regionalism and multilateralism as complementary rather than competitive.

Similarly, an empirical study conducted by the World Bank (2000) on trade creation and trade diversion effects of RTAs also underscored the complementarity between regionalism and multilateralism. The study revealed that in four of the seven countries analysed, there was no significant trade diversion, but in three countries the problem of trade diversion was noticeably large. The study concluded that diversion was neither so common as to be general nor so unusual as to be dismissible (World Bank, 2000). On the issue of complementarity, Baldwin (2000) considered regionalism as "half of the trade liberalization wheel" (implying that multilateralism was the other half). The present study takes this as the conceptual basis for analysing the potential impact of RTAs.

2.3 Nature, contours and economic analysis of South-South RTAs

There could be a theoretical justification for arguing that South-South RTAs, unlike North-South ones, are not beneficial for the participating countries, particularly the weaker ones. Indeed, there is even some empirical support for this argument. This can be due to one or more of the following factors.

First, in most South-South RTAs the share of intraregional trade is low. For example, in 2008, this share was 25 percent in ASEAN, 14 percent in Mercosur and 8 percent in the Andean Community (WTO, 2008a: 3). In the case of SAFTA, the figure was even lower, at 4.8 percent (IMF, 2010). Meanwhile, the shares of intraregional trade in North-South regional integration arrangements, such as the EU and NAFTA, are 68 percent and 51 percent respectively (WTO, 2008a: 3). Given the low volume of South-South intraregional trade, there is little incentive for the member countries to expand their trade through RTAs.

Second, most members of South-South RTAs tend to compete for the same markets – mostly industrialized-country markets. A classic example is that of textile and clothing exports from South Asian countries, which are concentrated in the two largest markets in the world – the EU and the United States. This, as the argument goes, could create a sense of competition rather than cooperation among the members of South-South RTAs.

Third, implementing an RTA is a costly exercise, entailing high coordination costs to administer strict ROO requirements and implement reform measures. Such measures require not only financial resources but also human resources, technical expertise and skills. Because these resources are limited or scarce in developing countries and LDCs, RTAs formed exclusively within and among them tend to be rather ineffective (Kelegama and Adhikari, 2002: 16).

Fourth, unlike the North, for many countries in the South, trade taxes are an important source of government revenue, which may decline when they become members of an RTA. This could occur directly as tariffs on intra-FTA trade are reduced and also indirectly when trade diversion occurs, such as when importers switch from importing goods from countries outside the RTA that are subject to tariffs (ibid.). In the context of SAFTA, loss of tariff revenue was a major fear expressed by the LDCs in general and Maldives in particular, where import duties make a significant contribution to government revenues: In 2005, such duties accounted for about 69 percent of the tax revenue and 31 percent of total revenue (Government of Maldives, 2006: 12).

Fifth, asymmetric trade creation and trade diversion, resulting from wide disparities in the economic size of the member countries, means that the relatively advanced members gain proportionately more than the relatively weaker members (Razzaque, 2008a). The World Bank (2000) and Venables (2003) cite two East African countries – Kenya (more competitive) and Uganda (less competitive) – as examples to support this point. Kenya was able to export more because of improved access to the Ugandan market, whereas Uganda not only lost because of the flooding of its domestic market by Kenyan imports that hurt its domestic manufacturers but also because it could not compete in the Kenyan market (even at zero duty) due to Uganda's greater comparative disadvantage. This led to income divergence, unlike in the case of RTAs among rich (or less poor) countries, where income convergence has taken place (e.g. Ireland, Greece, Portugal and Spain after joining the EU) (see, for example, Ben-David, 1993 and 1996). Therefore, within South-South RTAs, poorer countries, which are at a comparative disadvantage, are less likely to cooperate with one another. In fact, the collapse of the East African Common Market in 1977 is ascribed to the failure of poorer countries like Uganda and the United Republic of Tanzania to reap the benefits of trade liberalization because the entire benefits accrued to the relatively higher income country, Kenya.

Sixth, many countries of the South are signatories to more than one trade agreement. While this is not as prevalent among South Asian countries as among Latin American countries, such as Chile or Mexico, and many African countries, there are some countries in South Asia (India, Nepal and Sri Lanka) that are party to more than four RTAs.[12] Multiple memberships create complex situations due to overlapping ROOs and the burden of administering them

12 India is a member/signatory of the Bay of Bengal Initiative for Multi-Sectoral and Technical Economic Cooperation Free Trade Agreement (BIMSTEC FTA), SAFTA, the Indo-Nepal Trade Treaty, the Indo-Sri Lanka Free Trade Agreement, the Bangkok Agreement, the Indo-Singapore Comprehensive Economic Cooperation Agreement, and the Indian Ocean Rim – Association for Regional Cooperation (IOR-ARC). In 2010, India concluded an FTA with ASEAN and is currently negotiating an FTA with the EU. Nepal is a member of the BIMSTC FTA, SAFTA and the Indo-Nepal Trade Treaty and an observer of the Bangkok Agreement. Sri Lanka is a member of the BIMSTC FTA, SAFTA, IOR-ARC, the Bangkok Agreement, the Indo-Sri Lanka Bilateral Free Trade Agreement and the Pakistan-Sri Lanka Free Trade Agreement.

and may exhaust the scarce negotiating capital at the disposal of the members, as noted previously. Moreover, given the fact that the relatively more advanced countries tend to engage in more RTAs, weaker economies may suffer from possible trade deflection and preference erosion in the more advanced partner-country markets (Razzaque, 2008a). The weaker members thus face the possibility of being neglected, both as a market and as a supplier.

Recent analyses, both theoretical and empirical, which are critical of the preceding arguments, albeit in an indirect manner, tend to suggest that South-South RTAs can be welfare enhancing. Further, based on new insights, these studies also argue that, if appropriate measures are put in place, RTAs can offer considerable advantages even to the weaker economies. Each of these arguments is discussed below.

First, the arguments relating to North-South versus South-South trade agreements, despite having a sound theoretical backing, are not always supported empirically. Examples provided in most of the literature either cite the EU (which represents a rather extreme case of a North-South trade agreement) or the East African Common Market (which is another extreme case of a South-South trade agreement). Many of the analyses have not looked at other South-South trading arrangements to validate their findings. A study by Cernat (2003), which evaluated the impact of South-South trade agreements on intraregional trade flows as well as trade flows with countries outside the RTAs (non-members), came up with different findings. The study used a gravity model to analyse the *ex post* trade effects of seven South-South RTAs, namely the AFTA, the Andean Community, the Caribbean Community (CARICOM), the Common Market for Eastern and Southern Africa (COMESA), the Economic Community of West African States (ECOWAS), the Southern Common Market (Mercosur) and the Southern African Development Community (SADC). The results show that five of the seven South-South RTAs examined have been not only trade creating but also trade expanding, increasing overall trade even with third countries, sometimes quite significantly. The only exceptions are the Andean Community and Mercosur, where trade with non-members seems to have fallen, although they have achieved an increase in intraregional trade. The same study used a computable general equilibrium (CGE) model for an *ex ante* analysis of a Framework Agreement on a Trade Preferential System among the Member States of the Organization of the Islamic Conference and found that despite some potential for trade diversion, the net effect would be trade creation (ibid.).

Another empirical analysis conducted by Sanguinetti, Pantano and Posadas (2003) on Mercosur, focusing on the export diversification of Argentina within the region, suggests that the country has been able to take significant advantage of tariff liberalization, particularly in Brazil. The share of Argentina's exports to the Mercosur region as a whole has increased vis-à-vis third countries, suggesting that the South-South trade agreement has been beneficial for Argentina. These views are also supported by Nanda (2008), who argues that when countries at a similar level of economic development dismantle trade barriers, the negative effects in the form of deindustrialization, if any, get evenly distributed. He further suggests that the existing firms secure bigger market shares, which helps them increase their competitiveness through economies of scale. This is evident from their enhanced exports not only within the region but also outside (ibid.).

Second, the benefits of South-South RTAs should not only be seen in terms of intraregional trade but also in terms of intraregional investment. It has been empirically demonstrated that the transfer of resources and technology through South-South joint ventures is more appropriate and cost-effective for the receiving country than similar transfers made by transnational corporations based in industrialized countries. For instance, technology transferred through South-South joint ventures has been found to be appropriately scaled down to a smaller size, made more appropriate in relation to the factor endowments of the recipient developing countries, and adapted to local raw materials and market conditions (RIS, 2004). These joint ventures can also promote and supplement South-South trade. Joint ventures that have buy-back arrangements with the home country can help redress the perennial trade imbalances that may emerge because of the limited export capabilities of the host country (Kelegama and Adhikari, 2007).

In ASEAN, Japanese investment-driven exchanges have contributed to stimulating intraregional trade. ASEAN also started with limited complementarities in the 1970s, with the share of intraregional trade being only 6 percent, but by exploiting the investment-trade nexus, it has managed to increase its intraregional trade share to 25 percent at present. In the Greater Mekong region, infrastructure projects funded by the Asian Development Bank (ADB) stimulated the supply side and contributed to increasing trade among the member countries. These experiences, whereby dormant complementarities are invigorated through investment, have been well documented in the literature (ibid.).

Third, some of the studies that contend that South-South RTAs are not beneficial for the participating countries have not explored the possibilities offered by those agreements for exploiting the complementarities within the region through 'slicing up the value chain' and achieving overall growth in the trade of those RTAs with third countries. One such example is South Asia, where tremendous potential exists for such cooperation in the textiles and clothing (T&C) sector (Adhikari and Weeratunge, 2007). Similarly, Sawhney and Kumar (2008) suggest that there may still be scope for intra-industry trade, despite similar factor endowments and productivity levels, due to differences in skill levels and specialization. And Weerakoon and Thennakoon (2006) argue that the important structural changes that have taken place in intraregional trade in the recent past may be important indicators of future trends, including enhanced intra-industry trade. Increased value addition in the region, particularly in the T&C sector, could help several countries in the region that lack well-developed backward linkages to fulfil the ROO requirements, for example, of the EU on clothing exports, through "regional cumulation" (Adhikari and Weeratunge, 2007).

Fourth, the supply capacities of the LDCs are, by definition, limited. However, by assuming that these countries will never be able to improve their supply capacity in the future, despite global initiatives such as the Integrated Framework for Trade-Related Technical Assistance (IF, which has now moved to the 'Enhanced IF' (EIF) stage) and 'aid for trade', the studies may be underestimating the possible growth in the future supply capacities of the relatively weaker economies within South-South trade arrangements.[13]

Fifth, the role of S&D treatment, whereby the LDCs are often allowed some leeway in the commitments they are required to make and are provided with deeper concessions as well as compensatory transfers, is often ignored in most mainstream discussions. This may be because some mainstream trade economists (see, for example, Srinivasan, 1999; Sally, 2008) are opposed to S&D provisions, even within the multilateral trading system. The role of transfers provided by the EU to the relatively poor countries during their initial phase of integration into the EU and indeed the concept of 'variable geometry' adopted by the EU are often neglected in mainstream discussions. Similarly, the two-speed liberalization approach followed by ASEAN for the original members and late entrants – Cambodia, Lao People's Democratic Republic, Myanmar and Viet Nam – are often eschewed in mainstream discussions. However, Kelegama and Adhikari (2007) argue that if the regulatory framework in an RTA is correctly designed to accommodate the disparity between member countries, a small country can gain from an RTA. Citing the example of the Indo-Sri Lanka FTA, they contend that the time frame for tariff phase-out, ROO and negative lists were designed to accommodate the lower level of Sri Lanka's exports and production capacity and that this actually contributed to the success of the FTA.

From the foregoing discussion, it appears that the impact of South-South trade agreements on the welfare of the participating countries seems, at best, ambiguous. The arguments of some mainstream trade economists against such agreements should be viewed with caution as new evidence unfolds. Next, we examine whether or not the broad conclusion derived above is applicable in the context of South Asia.

2.4 Situating the debate in the South Asian context

Earlier studies on South Asian regional trade integration tended to be relatively more optimistic about the prospects of preferential trade liberalization in the region. For example, although Srinivasan and Canonero (1993) and Srinivasan (1994), using the gravity model, suggest that South Asia is better off undertaking unilateral liberalization, they nevertheless do find scope for some potential gains from preferential trade liberalization. They are of the view that smaller countries can gain more than larger countries from regional integration. Similarly, another study, by Pigato et al. (1997), based on CGE modelling, suggests that regional trade liberalization would generate significant welfare gains for India, but the gains to the other South Asian countries would in no way be smaller if they were to liberalize trade unilaterally.

13 See, for example, Malhotra (2006) on the potential role of aid for trade in helping developing countries in general and LDCs in particular overcome their supply-side constraints. Similarly, Adhikari (2011) suggests that, managed correctly, aid for trade could contribute significantly to alleviate supply-side constraints facing South Asian LDCs, in particular Bangladesh and Nepal.

The findings of most empirical studies on trade prospects and welfare effects of RTAs within South Asia conducted after the turn of the century have been dismal. This is largely because they observe considerable trade diversion as well as asymmetric benefits from the arrangements, as noted above. A study conducted by Bandara and Yu (2003), using the GTAP model to analyse the gains from SAFTA, concludes that India would take the lion's share of gains under SAFTA, whereas the others, except for Bangladesh, would obtain only marginal gains, and Bangladesh would lose out. The study also suggests that unilateral liberalization would produce greater benefits for South Asia compared with preferential liberalization under SAFTA. Although the latter finding is also shared by Panagariya (2003), he goes on to assert that countries with low tariffs, such as Sri Lanka, would gain significantly from the formation of an FTA in South Asia at the cost of a country like India, which maintains much higher MFN tariffs.

Similarly, two other studies, which make use of the gravity model to analyse the gains from SAFTA in terms of greater regional trade flows, find either no impact or an asymmetric impact. The first study, which uses an augmented gravity model, finds that Bangladesh, India and Pakistan are likely to gain from joining SAFTA, whereas Maldives, Nepal and Sri Lanka would lose out (Rahman, Shadat and Das, 2006). The second study, conducted by Rodriguez and Daniel (2007), predicts that the trade liberalization programme under SAFTA will have little effect, if any, on regional trade flows. Pitigala (2005) and Baysan, Panagariya and Pitigala (2006), on the other hand, contend that given the high level of protection in South Asia vis-à-vis the rest of the world (measured by MFN tariffs), there is a high risk of trade diversion. This underscores the need for a reduction in MFN tariffs in the region, a finding shared by Bandara and Yu (2003), Panagariya (2003) and Raihan and Razzaque (2007). The latter study, which is based on the GTAP model, estimates the trade creation and trade diversion aspects of the total welfare effects of various SAFTA scenarios. The study finds that full implementation of SAFTA will lead to welfare gains for India, Sri Lanka and the other South Asian countries, except Bangladesh, which will suffer a welfare loss. According to the study, Bangladesh's welfare loss will be driven mainly by a negative trade diversion effect (ibid.).

The findings of another study, by Razzaque (2008a), which combines a qualitative analysis with three types of quantitative analyses (gravity model, CGE model and GTAP), are more or less consistent with those of Bandara and Yu (2003). He contends that the weaker economies in the region would lose out significantly from SAFTA, at least in its current form. The study shows that the losses for the weaker economies would be due to increased imports from regional partners, only a nominal increase in exports to the region and a loss of tariff revenue. The latter is estimated to be quite substantial: 2.5 percent of gross domestic product (GDP) for Bhutan, 1.5 percent for Maldives and 1 percent for Nepal (Razzaque, 2008a: 10).

Although the LDCs were given some leeway by being allowed to maintain longer sensitive lists, and Bangladesh and Nepal have fully exploited this provision by including 1,254 and 1,335 tariff lines in their respective lists, developing countries were found to be equally crafty in maintaining their own sensitive lists. While Pakistan has designated 1,191 tariff lines in its sensitive list, Sri Lanka's list includes 1,079 tariff lines.

The findings of these studies need to be considered alongside those of several other studies, that have drawn favourable conclusions on the prospects of SAFTA, not only as a viable RTA but also as a stepping stone to multilateral trade liberalization. Some of them focus on the potential offered by a formal integration arrangement, such as SAFTA, to bring a huge amount of informal trade into the formal channel (Rahman, Shadat and Das, 2006; Kelegama and Adhikari, 2007; Sawhney and Kumar, 2008). Others point to the possibility offered by SAFTA of augmenting intraregional investment flows in order to exploit the dynamic gains from trade liberalization within the region (RIS, 2004; Rahman, Shadat and Das, 2006; Kelegama and Adhikari, 2007; Razzaque, 2008a), highlighting the complementarity between trade and investment cooperation within the region (Weerakoon and Thennakoon, 2006). This is despite empirical evidence suggesting that RTAs can increase intraregional flows of foreign direct investment but that the benefits are not likely to be evenly distributed (Yeyti, Stein and Daude, 2003).

On the issue of investment, the analysis made by RIS (2004) suggests that a SAARC investment area could facilitate an efficiency-seeking restructuring of industries in the region, thus enabling them to exploit economies of scale and specialization. In this event, according to the report, Sri Lanka could emerge as the region's shipping hub and also the hub for rubber-based industries, Bangladesh for energy-based industries, Bhutan for forest-based industries, India for information technology (IT) and textile industries and Maldives for fishery industries. The study does not specifically point out that Pakistan could be a hub for 'other textiles' (particularly those falling under Harmonized System (HS) code 63) industries and that Nepal could become a hub for herb-processing industries. An earlier study by Lama (2001), based on a report produced by Tata Economic Consultancy Services (1999) that identified 50 such sectors with investment potential in the region, also points to the country-specific investment potential of relatively larger South Asian countries.

A number of studies have emphasized the possibility of SAFTA to facilitate intra-industry trade and take advantage of the global supply chain network by 'slicing up the value chain' in myriad sectors, such as T&C (Mukherji, 2004; Adhikari and Weeratunge, 2007; Sawhney and Kumar, 2008), agriculture and food processing (Sawhney and Kumar, 2008), and paper and plastics (Mukherji, 2004). A major area for trade cooperation, which has not been covered by SAFTA thus far, is liberalization of trade in services (Sawhney and Kumar, 2008; Razzaque, 2008a). This sector offers potential not only to bring trade in informal services to the formal sector, thereby providing the dual benefits of trade creation (Rahman, 2002; Razzaque, 2008a; Sawhney and Kumar, 2008) and increased government revenue (Sawhney and Kumar, 2008) it also offers prospects for significant trade creation. A major reason for this is the greater capacity of SAARC countries to produce and trade in certain categories of services and the availability of high-quality services in the region. Equally important is the role of new economic geography in driving the tradability of certain services and creating scope for trade and investment complementarities within the region (Chanda, 2010:15). The services with potential for intraregional trade include energy, education, health, IT, transport and tourism (Kumar, 2008).

Other areas of cooperation that could help harness the intraregional trade potential include: improving supply capacity through investment in infrastructure, particularly road transport (De, 2005), harmonizing of regulatory standards (Rahman, Shadat and Das, 2006) and trade facilitation measures, including streamlining — if not completely eliminating — procedural bottlenecks (Sawhney and Kumar, 2008).

2.5 South Asian LDCs' perspective

SAFTA members include five LDCs, which are in no way homogeneous, despite being categorized by the United Nations as LDCs based on their per capita income, human assets index and economic vulnerability index (UNCTAD, 2008). In terms of size of economy, Bangladesh is much bigger than many developing countries in the world, including Sri Lanka within the region, but the vulnerability of its exports (measured by a high export concentration ratio) is greater than that of Nepal. Three landlocked countries – Afghanistan, Bhutan and Nepal – face different challenges, including reliance on a major transit country for their regional and international trade and therefore high transportation costs. Maldives is unique in the sense that as a low-lying island State it is highly vulnerable to the effects of climate change, but its per capita income is the highest in the region and therefore it is on the threshold of graduating to developing-country status. Maldives is also unique in its overwhelming reliance on tourism trade as well as its dependence on trade taxes for government revenue. Although Bangladesh, Bhutan and Nepal share tremendous potential for energy exports, Bhutan is the only LDC that has utilized this opportunity for expanding its trade in energy.

Despite these variations, regional trade remains an important source of external merchandise trade for the LDCs within the region. As shown in table 2.1, for three of the LDCs, intraregional trade constitutes a large proportion of their global trade: 81.8 percent for Bhutan, 63.27 percent for Nepal and 40.69 percent for Afghanistan. Bangladesh and Maldives do not have such a high degree of dependence on regional trade, because they export a major share of their merchandise to countries outside the region. Developing countries such as India and Pakistan do not trade much within the region; the share of intraregional trade in their total trade being 2.41 percent and 6.81 percent, respectively, although Sri Lanka, another developing country, trades reasonably well with its regional partners, their share being 17.33 percent of Sri Lanka's total trade. Of particular note is the share of the LDCs in intraregional trade (table 2.1, column 3), which is not significant. Bangladesh's share in regional trade (14.3 percent) is the second highest after India (39.01 percent), which is due to the former being the largest importer from the region, importing close to US$4 billion in 2008. It also has a 25 percent share in total intraregional imports.

Table 2.1: Regional merchandise trade of South Asian countries as percentage of overall trade, 2008

Country	Intraregional trade (US$ million)	Share in intraregional trade (%)	Global trade (US$ million)	Share of intraregional trade in global trade (%)
Afghanistan	2,506	8.24	6,159	40.69
Bangladesh	4,347	14.30	37,724	11.52
Bhutan	335	1.10	409	81.80
India	11,859	39.01	491,168	2.41
Maldives	234	0.77	1,627	14.36
Nepal	2,990	9.84	4,726	63.27
Pakistan	4,191	13.79	67,800	6.18
Sri Lanka	3,939	12.96	22,730	17.33
Total	30,401	100	632,343	4.81

Source: International Monetary Fund, 2010.

Note: Because data for Bhutan's trade are not available, they are calculated based on the export and import data of Bhutan's trading partners.

Despite their excessive dependence on regional trade, LDCs, with the possible exception of Bhutan, are increasingly being marginalized in the SAFTA in terms of exports. Their imports from the region are increasing more rapidly than their exports to the region, with the result that their shares in intraregional exports have been shrinking, causing widening trade deficits (table 2.2). Although Afghanistan is a recent entrant to SAFTA and baseline data for Bhutan are not available, table 2.2 suggests that Bangladesh is the only LDC that has managed to increase its exports to the region more than its imports from the region. The intraregional exports of both Maldives and Nepal have failed to keep pace with the rise in their intraregional imports, while the reverse is true for developing-country members, such as India and Pakistan (Adhikari, 2010).

Table 2.2: Intraregional merchandise trade in South Asia, 2000 and 2008

Country	Exports to the region (US$ million)		Imports from the region (US$ million)		Share in intraregional exports (%)		Percentage change
	2000	2008	2000	2008	2000	2008	2000-2008
Afghanistan	60	175	169	2,331	2.09	1.18	-43.54
Bangladesh	93	431	1,050	3,916	3.21	2.92	-9.03
Bhutan	–	164	–	171	–	1.11	–
India	1,820	9, 449	454	2,410	62.97	64.01	1.65
Maldives	14	18	90	216	0.48	0.12	-75.00
Nepal	309	881	587	2,110	10.7	5.97	-44.21
Pakistan	404	2,919	291	1,272	13.99	19.77	41.32
Sri Lanka	190	725	707	3,213	6.57	4.91	-25.27
Total	2,890	14,762	3,348	15,638	100	100	

Source: IMF, 2010.

Note: For Bhutan, see note to table 2.1.

If economic theory and the empirical analyses conducted so far are any guide, the LDCs in the region will lose out from SAFTA. If the agreement is limited to trade in goods only, and if other areas of cooperation are not explored, trade and economic growth in the LDCs are likely to erode even further (Kelegama and Adhikari, 2007; Sawhney and Kumar, 2008; Razzaque, 2008a). This is the second conceptual basis that guides further analyses made in the subsequent chapters.

Chapter 3

An assessment of SAFTA from the LDCs' perspective

3.1 Introduction

South Asian LDCs share a number of common features, but their macro indicators, including population, GDP and extent of trade integration, are very different. The LDCs have not benefitted much from their integration into the global economy, despite the liberal trade policies they have adopted over the past two decades. Although the share in global trade of LDCs as a group has increased in recent years, the global figures mask the relatively higher levels of exports achieved by the so-called 'well performing' LDCs and the continued marginalization of some of the others.

Within South Asia, LDCs are the worst performing countries in their level of trade integration, both globally and regionally, despite the generous preferential market access opportunities available to them. The problems faced by the South Asian LDCs in their quest for global integration are similar to those faced by them in the regional market. This chapter explores three such problems: a) their difficulties in penetrating the largest market in the region, b) preference erosion resulting from various intraregional and transregional trade arrangements being pursued by some countries in the region and c) the limited comparative advantage of South Asian LDCs in the manufacturing sector.

3.2 Macro indicators of South Asian LDCs

In terms of broad economic indicators, Bhutan and Maldives rank higher than the other three LDCs. Although the per capita GDP for Maldives reached US$4,135 in 2008, for Bhutan it was US$ 1,869, and for Afghanistan, Bangladesh and Nepal it was much lower (table 3.1). Bangladesh is the most populous LDC not only in South Asia but also in the world, with the population reaching 160 million in 2008. Afghanistan and Nepal, too, have fairly large populations, at 29.02 million and 28.18 million, respectively. Bhutan and Maldives have 686,789 and 305,027 inhabitants, respectively. In terms of size of the economy, Bangladesh is the largest among the South Asian LDCs, with a GDP of US$79,554 million, followed by Nepal (US$12,615 million) and Afghanistan (US$10,624 million). However, Bhutan and Maldives, which are considered typical small economies, have GDPs of US$1,283 and US$1,261 million, respectively.

Table 3.1: Basic indicators of South Asian LDCs, 2008

Country	Population (million)	Land area (Sq.km)	GDP (current US$ million)	Annual GDP growth rate (%)	GDP per capita (current international dollars)	Imports of goods and services (% of GDP)	Exports of goods and services (% of GDP)	Trade (% of GDP)
Afghanistan	29.02	652,090	10,624	2	366	53	17	70
Bangladesh	160.00	130,170	79,554	6	497	29	20	49
Bhutan	0.69	38,394	1,283	14	1,869	51	56	107
Maldives	0.31	300	1,261	5	4,135	110	83	194
Nepal	28.81	143,350	12,615	5	438	33	12	45

Source: World Bank, 2010a.

In terms of trade-related indicators, Maldives is the most open economy, with a trade-to-GDP ratio of 194 percent, followed by Bhutan (107 percent) and Afghanistan (70 percent). Bangladesh and Nepal are moderately open, with a merchandise trade-to-GDP ratio of 49 percent and 45 percent, respectively (table 3.1).

3.3 LDCs' position in global trade

The 49 poorest countries in the world are categorized by the United Nations as LDCs on the basis of three criteria, as noted earlier: low per capita income, a weak human assets index and a high economic vulnerability index (UNCTAD, 2008). These countries, which host 12 percent of the world's population, collectively account for less than 2 percent of global GDP (Bhattacharya, 2010). The economic growth rates of a significant number of LDCs have been abysmally low, and the poverty reduction effects of such growth are likely to remain weak (UNCTAD, 2007).

Despite their generally lacklustre economic performance, trade integration of the LDCs over the past two decades has been one of the most rapid in history. The degree of integration of the LDCs – measured by the extent of trade liberalization – is higher than that of many high- and middle-income countries. Whether trade liberalization is measured by the level of tariff barriers and NTBs or by trade-to-GDP ratio, the LDCs are generally more liberal than some developing countries (Raihan Adhikari and Adhikari, 2007). Despite their high degree of openness, the LDCs' performance in terms of increased trade (mainly export trade) to achieve sustained economic growth and poverty reduction has not been encouraging.

On the face of it, the LDCs have increased their share in world trade, which reached 1.1 percent in 2008 (WTO, 2009). However, what is hidden behind this figure is the fact that seven LDCs that export oil and readymade garments accounted for the lion's share – 73.8 percent– of LDC exports (table 3.2),[14] which means the other 42 LDCs had an export share of only 26.2 percent in the global merchandise exports of LDCs. While the export growth of those seven major exporters has contributed to respectable growth in their GDP, their performance on both counts cannot be considered sustainable because oil prices

14 The figure does not include the exports of Timor-Leste, for which data were not available.

declined to a record level in early 2009 and picked up only slightly later that year. Similarly, the readymade garment exports of Bangladesh and Cambodia have also shown signs of growing at lower rates than in the past few years. Both trends are attributed to the slower demand for these commodities in industrialized countries due to the global economic meltdown.

Table 3.2: Share of seven major LDC exporters in total LDC exports

LDC	Major export	Merchandise exports (US$ billion)		Percentage of LDC merchandise exports		Percentage change in export value	
		2008	2007	2008	2007	2000–2008	2007–2008
Angola	Oil	67.1	39.9	38.1	33.3	31	51
Bangladesh	Readymade garments	15.4	12.5	8.8	10.4	12	23
Cambodia	Readymade garments	4.3	4.1	2.4	3.4	15	5
Chad	Oil	4.7	3.5	2.7	2.9	50	27
Equatorial Guinea	Oil	16.3	10.0	9.3	8.3	40	60
Sudan	Oil	12.1	8.9	6.9	7.4	27	36
Yemen	Oil	10.0	7.3	5.7	6.1	10	27
Total		129.9	86.2	73.8	71.8		

Source: WTO, 2009; 2008b.

Notwithstanding these disappointing results, including asymmetric benefits, the LDCs have been making every possible effort to integrate their economies into the global economy. Of the 49 LDCs, 33 are already members of the World Trade Organization (WTO) and nine others are at various stages of the accession process (Adhikari, Dahal and Pradhanang, 2008). It is not only for economic reasons that they are being driven to integrate; political economy considerations are also important, such as 'locking-in' domestic reform, becoming part of the global economic community and, for landlocked countries, securing predictable access to transit routes (Adhikari, 2005).

The LDCs are poorly represented in the WTO, with some 20 LDCs not having any permanent representation in Geneva. Thus their ability to influence the decision-making process of the WTO is extremely weak (De Vylder, 2007: 34). Their capacity to analyse trade negotiation issues and make an informed judgement is limited, even among capital-based officials (ibid.). Most LDCs are reluctant to engage non-state actors in trade policy-making processes, although some changes have occurred recently in select countries (Rajkarnikar, 2005). Due to growing awareness of the limited benefits the WTO has brought to their economies, they are now becoming highly vocal and have shown remarkable unity when pressing for key demands. These general observations apply equally to the South Asian LDCs, as elaborated in the next section.

3.4 Trade policy context

Overall, the trade policies of most South Asian LDCs are influenced by the prevailing orthodoxy of the time, which is why they exhibit some degree of similarity. Most LDCs followed protectionist trade policies during the heyday of import-substituting industrialization (ISI). When balance-of-payments crises led these countries to seek assistance from the Bretton Woods institutions, those institutions, guided by the Washington Consensus, 'advised' them to pursue policies of rapid trade liberalization. Consequently, they embarked on a path of 'unilateral' or 'autonomous'[15] trade liberalization by substantially reducing their tariffs and NTBs[16] and signed various trade agreements in order to 'lock in' trade liberalization. Although Bangladesh, Maldives and Nepal are members of the WTO, they made different sets of commitments at the time of their accession.[17] Afghanistan and Bhutan are in the process of acceding to the WTO.

Four LDCs, which were among the founding members of SAARC (Bangladesh, Bhutan, Maldives and Nepal), participated in SAPTA, which was eventually converted to an FTA in the form of SAFTA.[18] Afghanistan, a recent entrant to SAARC, has also become a member of SAFTA. Bangladesh, Bhutan and Nepal are also members of the BIMSTEC FTA (consisting of countries of South Asia and South-East Asia), which aims to reduce the tariff barriers of the participating countries[19] by 2017. It is much more far-reaching than SAFTA in the sense that it not only covers trade in goods but also seeks to cover services, investment, technology and human resources (Ministry of Foreign Affairs, 2009).

Another major similarity between Bangladesh, Maldives and Nepal (apart from all three being members of the WTO) is that the composition of their exports has changed significantly in recent years, from mainly primary commodities to mainly manufactured products (UNCTAD, 2008). This achievement would not have been possible without global market imperfections in the T&C sector, a direct consequence of the Multi-Fibre Arrangement (MFA).

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15 Although there are doubts as to whether these measures were truly 'unilateral' and 'autonomous' or were externally driven (see Adhikari, 2009b).

16 These are considered the main elements on which a country's openness to external trade is measured (Rodrik, 2002).

17 For example, by virtue of being a founding member of the WTO, Bangladesh is among the countries with the lowest level of commitments. On the other hand, Nepal, having acceded to the WTO much later, in 2004, has had to make commitments that are among the highest of all the LDC members of the WTO. For a comparison of the commitments made by these two countries, see Adhikari (2005). Similarly, Maldives, which is another founding member of the WTO, was not required to make extensive commitments at the time of its accession to the WTO. However, Afghanistan and Bhutan, which are yet to become WTO members, are likely to face similar conditions to those of Nepal.

18 The seven founding members of SAFTA are Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka. Afghanistan joined later, following its entry into SAARC.

19 Members of BIMSTEC are: Bangladesh, Bhutan, Indian, Myanmar, Nepal, Sri Lanka and Thailand.

The MFA restricted imports from competitive countries so as to provide opportunities to relatively less competitive countries, like Bangladesh, Maldives and Nepal, to enable them to take the first steps towards export-oriented industrialization.[20] However, Afghanistan and Bhutan could not take advantage of this opportunity. The MFA was later integrated into the Agreement on Textiles and Clothing of the WTO and phased out in 2005, with the result that Maldives has been completely wiped off from the map of T&C-exporting countries, and Nepal is likely to face a similar fate unless it makes conscious efforts to diversify markets (Adhikari and Yamamoto, 2007; Adhikari and Weeratunge, 2007).

Finally, all South Asian LDCs have been beneficiaries of the preferential market access facilities granted by industrialized countries. As a culmination of various efforts to facilitate the integration of developing countries into the world economy, members of the GATT decided to introduce an Enabling Clause[21] into the multilateral trading system, which institutionalized the process of granting preferential market access to developing countries on a non-reciprocal and non-discriminatory basis. This clause, which also envisages deeper preferences for the LDCs (GATT, 1979; see also Pandey, 2003), has indeed helped several developing countries in the process of their industrial development (see, for example, Hoekman, Ng and Olarreaga, 2001; UNCTAD and Commonwealth Secretariat, 2001; Khatun, 2007). Under this arrangement, various industrialized countries have provided duty concessions to developing countries, but the EU has been at the forefront of providing preferences to the LDCs.[22] In May 2001, the EU announced a DFQF market access initiative for the LDCs, popularly known as the Everything-But-Arms (EBA) initiative. This initiative allows LDCs to export virtually everything to the EU free of duty, except for arms and ammunition and three sensitive items (rice, sugar and bananas), although later these three items were phased in. The LDCs in general have not been able to benefit substantially from this arrangement, primarily due to stringent ROO requirements.[23]

An analysis of the trade patterns of the South Asian LDCs suggests that, barring Bangladesh, which has done remarkably well in terms of exports of readymade garments, other LDCs are on the verge of being marginalized in the global trading system. As can be seen in table 3.3, despite having low average tariffs and liberal trade regimes, as reflected by low average applied tariffs and high trade-to-GDP ratios (shown in table 3.1), their shares in global trade remain dismally small. For example, Afghanistan and Bhutan have minuscule shares in world trade, particularly world exports, which are not even captured by the global trade data up to two decimal points. Even a high-performing exporter such as Bangladesh has only a 0.02 percent share in global exports, despite its being home to 2.67 percent of humanity.

20 For further details, see Adhikari and Yamamoto, 2007.

21 This clause is more formally known as Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries" (GATT, 1979).

22 For further details, see Inama, 2002 and UNCTAD, 2004.

23 See, for example, Inama, 2002 and Khatun, 2007.

Table 3.3: Trade profiles of South Asian LDCs, 2008

LDC	WTO membership	Final bound tariff (%)	Average applied tariff (%)	Share in world exports (%)		Share in world imports (%)	
				Goods	Services	Goods	Services
Afghanistan	In process of accession	-	5.6	0.00	-	0.02	-
Bangladesh	Founding member	169.2	14.4	0.10	0.02	0.14	0.10
Bhutan	In process of accession	-	21.9	0.00	0.00	0.00	0.00
Maldives	Founding member	36.9	20.4	0.00	0.02	0.01	0.01
Nepal	Acceded in 2004	26.0	12.7	0.01	0.01	0.02	0.02

Source: WTO, 2009.

3.5 A critical analysis of SAFTA

Several commentators suggest that, as an RTA, SAFTA can be considered as 'too little, too late' (Hashim, 2007; Weerakoon, 2009). This is because when SAPTA was launched as a precursor to SAFTA, the positive list approach adopted for the liberalization of tariffs allowed little progress on trade liberalization. It was at a time when competing South-South RTAs (such as AFTA and Mercosur) were moving rapidly to dismantle trade barriers. The four rounds of SAPTA negotiations revealed that while the participating countries appeared to be generous in terms of the number of concessions offered, the trade coverage was extremely limited (Kelegama and Adhikari, 2007). And, according to Weerakoon and Wijayasiri (2001), many of the goods for which concessions were offered for stimulating trade were irrelevant because they largely excluded the products of export interest to the trading partners.

Due to the ineffectiveness SAPTA, drafters of SAFTA were more accommodating towards a negative list approach to trade liberalization. Their ambivalence was once again exposed when they decided to postpone the negotiations on sensitive goods. This encouraged protectionist interests in each country to unite in favour of maintaining extensive sensitive lists. This tendency, coupled with the mercantilist mindset of the trade negotiators, meant that allowing members to designate up to 20 percent of their tariff lines in the form of sensitive lists was just a formality with which the eighth round of the Committee of Experts (COE) meeting in Kathmandu in April 2005 dutifully complied.[24] This gave a clear message that South Asians, despite their political rhetoric, were not interested in pursuing a genuine FTA.

24 Based on a personal conversation with Dr. Posh Raj Pandey, who represented the Government of Nepal at the COE meeting and decided to opt out of the negotiations because of his frustration with what he described as "everybody trying to protect their own turf" and "a lack of interest amongst the negotiators on liberalizing trade and contributing to meaningful regional integration."

Although the LDCs were given some leeway by being allowed to maintain longer sensitive lists, and Bangladesh and Nepal have fully exploited this provision by including 1,245 and 1,310 tariff lines in their respective lists, developing countries were found to be geared towards maintaining their own sensitive lists. While Pakistan has designated 1,183 tariff lines in its sensitive list, Sri Lanka's list includes 1,065 tariff lines. Meanwhile, Bhutan's and Maldives' sensitive lists, which cover only 157 and 671 tariff lines, respectively, reflect the narrow range of goods imported by these countries. India's original sensitive list containing 884 tariff headings was relatively undersized, considering the total volume of its trade with the countries in the region (see table 5.1 in chapter 5), although products were meticulously chosen to afford adequate protection to the domestic producers in India. As discussed further on, India has unilaterally decided to reduce its sensitive list twice, which is not only commendable but also worthy of replication by other countries in the region.

Perhaps of greater concern is the fact that there is no formal and binding provision in the SAFTA agreement to prune sensitive lists over time. In contrast, AFTA requires explicitly that the products on its sensitive list — called the Temporary Exclusion List — be phased out in five equal instalments. SAFTA only provides for a "review" of the sensitive list at least once every four years "with a view to reducing the number of items" (SAARC, 2004). The underlying intention may be to prune it, but the provision is very vague and lacks 'teeth' in the sense of requiring member countries to reduce the number of items on their lists. Given that SAFTA has left the issue of sensitive lists fairly open-ended — and even four years is a fairly long period for improvement — there is a danger that SAFTA will fall short of free trade even in the long run.[25] Indeed, the trade-restricting nature of the sensitive lists was highlighted by a study commissioned by UNDP, which found that 53 percent of the actively traded goods in South Asia fall in the sensitive lists (Weerakon and Thennankoon, 2006). This implies that the market access gains envisaged by SAFTA are not likely to be realized until this issue is resolved.

3.6 Problems with LDC participation in SAFTA

Before looking at the problems associated with LDCs' participation in SAFTA, it is necessary to examine overall trade within the region. As discussed in chapter I, total intraregional trade among SAARC countries amounts to only 4.8 percent of their total foreign trade. However, the LDCs are highly dependent on the regional market for their trade and particularly on the two largest economies of the region, namely India and Pakistan, which account for 92 percent of LDCs' exports and 78 percent of their imports. While Bangladesh, Bhutan and Nepal are significantly dependent on India for their exports and imports, Afghanistan is more dependent on Pakistan than on India, but nevertheless dependent on both these countries for more than 99 percent of its regional trade (table 3.4). Similarly, Maldives is more dependent on Sri Lanka for its exports and highly dependent on India for its imports (not shown in the table).

25 Although in 2009, the SAFTA COE decided that each participating country should reduce its sensitive list by 20 percent, the real impact in terms increasing the trade potential of the LDCs can be assessed only after the actual reductions take place.

Table 3.4: LDCs' trade dependence on the two largest economies in South Asia, 2008

Country	Exports					Imports				
	India (US$ million)	Pakistan (US$ million)	To India and Pakistan (US$ million)	Intra-regional total (US$ million)	Share of exports to India and Pakistan (%)	India (US$ million)	Pakistan (US$ million)	From India and Pakistan (US$ million)	Intra-regional total (US$ million)	Share of imports from India and Pakistan (%)
Afghanistan	89	85	173	175	99.05	277	2051	2,329	2,331	99.90
Bangladesh	330	79	409	431	94.82	3,498	297	3,795	3,916	96.90
Bhutan	148	1	149	164	90.72	167	0	168	171	98.04
Maldives	2	0	2	18	9.75	147	5	152	215	70.64
Nepal	798	4	801	881	90.95	2,099	4	2,103	2,110	99.66
Total	1,366	168	1,534	1669	91.90	6,188	2,357	8,546	10,903	78.38

Source: Author's calculations, based on IMF, 2010.

Note: For Bhutan, see note to table 2.1.

This also implies that the LDCs do not trade much among themselves, and except for Maldives, they do not even trade much with Sri Lanka, another developing-country member of SAFTA. Because these high levels of LDCs' intraregional trade concentration are considered dangerous, efforts should be made to diversify their intraregional trade. And yet, there are enormous barriers to increasing their exports to their traditional trading partners within the region, as discussed further on.

3.6.1 Difficulties penetrating the Indian market

The prospects for increasing South Asian LDCs' exports to India are hampered not only by India's high MFN tariffs (37.6 percent, on average), but also by India's sensitive list that includes products of export interest to the LDCs, such as vegetable products (representing 20.2 percent of tariff lines) and textile products (representing 34.2 percent of tariff lines) (Sawhney and Kumar, 2008). As noted, for small LDCs, including Afghanistan, Bhutan and Nepal, India is a leading destination market. Yet India maintains the highest applied MFN tariffs on goods traded within the region compared with other markets, and only a small share of imports (by value) from the LDCs enter India duty-free (ibid.). For example, India is the second-largest export market for Afghanistan, but imports from Afghanistan face a weighted average MFN tariff of 45.5 percent in India, and only 17.8 percent of Afghanistan's imports into India are duty-free. Although on paper India has a PTA with Afghanistan, only a few items receive preferential treatment. On the other hand, the Indo-Nepal Trade Treaty is highly liberal from Nepal's perspective due to virtually non-reciprocal[26] duty-free market

26 Nepal's industrial products are offered non-reciprocal zero tariff access to the Indian market; but for the primary products listed in the Treaty, reciprocity applies.

access provisions. However, the weighted average MFN tariff on Nepalese imports is 22.4 percent,[27] and only 14.7 percent of these imports enter India duty-free (ibid.).

The matter is further complicated by the extensive use of para-tariff barriers and NTBs, including rigid ROO requirements (Raihan, 2009; Rahman, 2010). NTBs are particularly pernicious due to their non-transparent nature and often arbitrary application, as illustrated by the following examples: the imposition of tariff rate quotas on Nepal's exports of vegetable ghee, acrylic yarn, copper and zinc oxide under the supposedly liberal Indo-Nepal Trade Treaty (Raihan et al., 2007); the imposition of a rule that permits imports of pharmaceutical products only through three land customs stations, excluding the Kolkata port and Petrapole land customs station – the two major trading points for Indo-Bangladesh trade (Sawhney and Kumar, 2008); and the imposition of an anti-dumping duty on acid battery exports from Bangladesh to India, even though that measure violates WTO rules (Raihan and Razzaque, 2007).

Moreover, a recent and fairly comprehensive study conducted by the Centre for Policy Dialogue to explore the prospects of and analyse the impediments to a proposed bilateral trade agreement between Bangladesh and India reveals that standards-related barriers are the most frequently used NTBs in South Asia (table 3.5), a major user of which happens to be India (Rahman, 2010). This is corroborated by Raihan (2009:15), who observes: "Although Bangladeshi exporters face some NTBs in Pakistan [the second major market for Bangladeshi exports to the region], the major NTBs they face in South Asia are in the Indian market."

Table 3.5: Share of various NTBs in all NTBs imposed by South Asian countries

Non-tariff measures	Share (%)
SPS, TBT and other related measures	86.3
Tariff quotas	9.8
Anti-dumping measures	7.4
Licence requirements	5.2
Countervailing measures	1.2

Source: Rahman, 2010, based on ADB/UNCTAD, 2008.

Note: The shares do not add up to 100 percent because some products face multiple NTBs.

SPS= sanitary and phytosanitary; TBT= technical barriers to trade

Rahman (2010) also compares the NTBs prevalent in ASEAN with those mentioned previously and finds that technical measures and regulations, such as sanitary and phytosanitary measures and technical barriers to trade (TBT), account for only 14.8 percent of the NTBs imposed on intraregional trade in ASEAN, where standards-related NTBs are

27 This becomes relevant when Nepalese exports do not meet the ROO requirement and thus become ineligible for preferential market access.

mostly resolved through agreements pertaining to mutual recognition of standards and certification systems.

3.6.2 Preference erosion

The LDCs in South Asia are as likely to face preference erosion at the regional level as at the multilateral level. Because India is the major market for their exports, any FTA or preferential market access arrangements India might enter into on a bilateral or multilateral basis within the region or outside the region are likely to result in preference erosion for the LDC members of SAFTA. For example, when India signed FTAs with Nepal and Sri Lanka, it resulted in preference erosion mainly for Bangladesh, although, fortunately, not of a significant magnitude. However, the FTA India is expected to sign with the EU, giving the parties preferential access to each other's markets, is likely to result in significant preference erosion for the LDCs (Razzaque, 2008a; Winters et al., 2009). Table 3.6 shows estimates of the extent to which an EU-India FTA would increase the vulnerability of other SAARC members' exports to the Indian market. As is evident from the table, Nepal and Bhutan are likely to suffer the most from increased competition from the EU (57. 5 percent in the case of Bhutan and 27 percent in the case of Nepal). This is confirmed by Winters et al. (2009), who estimate that Bangladesh is likely to lose US$102 million worth of exports and Nepal could lose US$22 million. Although Bangladesh, Nepal, Pakistan and Sri Lanka would suffer the most as a result of average tariff reduction in India for EU goods, in terms of percentage of total trade that is relatively vulnerable to terms-of-trade pressure, Nepal (with 17.58 percent) is likely to suffer the most, followed by Bhutan (9.96 percent).

Table 3.6: Estimated effects of an EU-India FTA on South Asian countries' exports to India

Country	Percentage of total exports affected by increased competition from the EU	Average tariff reduction for EU on goods also exported by the excluded country	Percentage of total trade relatively vulnerable to terms-of- trade pressure
Afghanistan	0.5	20.7	1.04
Bangladesh	0.6	24.4	0.07
Bhutan	57.5	18.1	9.96
Maldives	1.7	17.8	0.28
Nepal	27.0	22.6	17.58
Pakistan	0.4	23.0	0.09
Sri Lanka	5.8	20.6	2.13

Source: Winters et al., 2009.

The extent of preference erosion is likely to be high because any RTA/FTA in which even a single developed country participates, such as the EU-India FTA, needs to be reported to the WTO under GATT Article XXIV. And that Article requires that the signatories liberalize "substantially all the trade", thereby setting a higher threshold for liberalization. Only those agreements that are entered into between developing countries, such as SAFTA and AFTA, can be notified under an alternate mechanism provided by the Enabling Clause, which permits non-reciprocal trade agreements and does not specify the liberalization threshold.

Similarly, the DFQF market access provided by India to all the LDCs, the primary targets of which are the African LDCs (Adhikari et al., 2008a), can result in significant preference erosion for the South Asian LDCs. The magnitude of that erosion has not been determined by any study so far. A study conducted by Laborde (2008), which analyses the potential impact of the granting of full DFQF market access to LDCs by five emerging economies, particularly India, estimates the losses for Nepal resulting from preference erosion to be US$7 million, though no loss is predicted for Bangladesh.

3.6.3 Limited comparative advantage in the goods sector

Most LDCs in the region have a much greater comparative advantage in services than in goods, although some of them do possess a comparative advantage in certain products for export to the region. For example, Bangladesh has a comparative advantage in its exports of fish, vegetables, jute, fertilizer (Sawhney and Kumar, 2008) and light engineering products (Raihan et al., 2007) to the region, while Nepal has a comparative advantage in its exports of oilseeds, oleaginous fruits (Sawhney and Kumar, 2008) and herbal products (Raihan et al., 2007). Similarly, Bangladesh, with more than US$15 billion worth of T&C exports, has some comparative advantage in the labour-intensive segment of readymade garments, and it also has a natural comparative advantage in energy exports, which remains underutilized. Likewise, Bhutan and Nepal share a similar level of comparative advantage in hydro electricity supply, which is hugely underutilized, particularly in Nepal. The Maldives and Nepal share a comparative advantage in the tourism trade, which also is underutilized in the context of Nepal. Although most of the LDCs in the region are net importers of health and education services, they are likely to reap net benefits from trade in services (Kumar, 2008). A study commissioned by the Ministry of Commerce, Government of Nepal and UNDP found that Nepal possesses a comparative advantage in high-end retail, health and education services but that potential has remained underutilized due to regulatory impediments (SAWTEE, 2008). Because services are not yet included in SAFTA, these LDCs have been unable to realize the full potential for gain from the regional trade in services.

Chapter 4

Impediments to effective participation of the LDCs in SAFTA

4.1 Introduction

There is a general tendency to attribute the lower level of participation of the LDCs in RTAs to the smallness of their economies. Although standard trade theory considers small size an advantage in international trade and, by extension, in regional trade (see, for example, Thomas, 2004), it is often the smaller countries that are marginalized in trading systems and arrangements. Given the political, if not economic, imperative to help the LDCs integrate their economies into trading systems and arrangements, various forms of S&D treatment are accorded to them. As a rule, countries with large domestic markets are believed to have an advantage in trade negotiations, because they are able to use both carrot (opening up the market) and stick (threat of market closure) (see, Barton et al., 2008; Adhikari, 2009b), but small economies in general, and LDCs in particular, do not have such a bargaining lever.

South Asia is uniquely positioned to defy this rule. For example, Bangladesh, despite being an LDC, has a much bigger domestic market than Sri Lanka (a developing country) and possesses significant negotiating clout in trade negotiations. To reiterate a point made earlier, all the LDCs cannot be treated alike when examining factors that impede their effective participation in SAFTA processes and outcomes. This is mainly because there are wide variations among them in terms of their geographic situation (which affects accessibility), institutional endowments (which affect regulatory quality), negotiating capital (which affects negotiation outcomes) and systems of governance (which affects political economy outcomes). Therefore, the constraints discussed in this chapter may not be applicable to all the LDCs alike; some may differ in type and others in magnitude. With these general caveats, this chapter discusses the impediments to South Asian LDCs' meaningful participation in SAFTA.

4.2 Structural and institutional constraints

The LDCs, by definition, are structurally handicapped, which explains their high economic vulnerability index — one of the three criteria discussed in chapter I for the inclusion of countries in the LDC group. This section revisits some of the structural constraints mentioned in previous chapters and identifies additional ones.

One of the major structural constraints confronting the South Asian LDCs is their high level of export concen-tration and thus their economic vulnerability to external shocks. For example, Bangladesh has a high export concentration in readymade garments, Maldives in fish (merchandise) and tourism (commercial services) and Bhutan in electricity. At the same time, Nepal's and Bhutan's excessive reliance on India, both as an import source and export destination, is the major reason for their economic vulnerability. A major economic shock in the Indian market or a major change in its policy towards these smaller neighbours could have a devastating impact on their economies. Therefore, the need for export diversification, in terms of both products or services as well as trading partners, is a major thrust of the trade policies of these countries. The outcomes, however, have not been encouraging so far.

Several studies have shown that the quality of institutions can have a significant impact on export growth and, indeed, on overall growth of the economy (see, for example, Rodrik, 2002; Rodrik and Subramanian, 2003; Rodrik, Subramanian and Trebbi, 2004). In South Asian LDCs, institutions, in terms of their regulatory quality, the rule of law and measures for controlling corruption, tend to be of poor quality when compared with those of the developing countries of the region (table 4.1)

Table 4.1: Quality of institutions in South Asia, 1998 and 2008 (estimates)

Country	Regulatory quality (-2.5 to + 2.5 best)		Rule of law (-2.5 to + 2.5 best)		Control of corruption (-2.5 to + 2.5 best)	
	2008	1998	2008	1998	2008	1998
South Asian LDCs						
Afghanistan	- 1.58	-2.15	-2.01	-1.71	-1.64	-1.91
Bangladesh	-0.82	-0.59	-0.7	-0.82	-1.1	-0.73
Bhutan	-0.86	-0.43	0.37	0.27	0.72	0.67
Maldives	-0.42	0.85	-0.24	0.4	-0.6	0.1
Nepal	-0.66	-0.42	-0.76	-0.14	-0.68	-0.18
Benchmark countries						
India	-0.21	-0.39	0.12	0.23	-0.37	-0.31
Pakistan	-0.47	-0.47	-0.92	-0.73	-0.77	-0.82
Sri Lanka	-0.28	0.29	-0.01	-0.11	-0.15	-0.12

Source: Kaufmann, Kraay and Mastruzzi, 2009.

The estimates provided in the table indicate that only Bhutan seems to have a reasonably good quality of institutions among the LDCs. Although Maldives has better scores than other LDCs as well as Pakistan (a developing country), it seems to have neither a satisfactory regulatory quality nor a favourable institutional environment for the control of corruption. In terms of quality of institutions, the other LDCs are not only worse than the two benchmark developing countries (India and Sri Lanka) but also significantly worse than Bhutan.

A comparison of the estimates for 2008 and 1998 provides some indication of the magnitude of improvement or deterioration in the institutional indicators. The comparison reveals that there has been a significant deterioration in institutional quality in most South Asian LDCs during this period. For example, in terms of regulatory quality, only one LDC – Afghanistan – has shown an improvement, whereas among developing countries, the indicator for India has improved while that for Pakistan has remained unchanged. Sri Lanka, however, seems to have experienced a sharp deterioration. As regards the rule of law, except for Bangladesh and Bhutan, there has been a significant deterioration in all the other LDCs but less of a deterioration in two of the developing countries of the region, namely India and Pakistan, while in Sri Lanka there has been marginal improvement.

With regard to control of corruption, there has been moderate improvement in Afghanistan and Bhutan but a sharp deterioration in Maldives and Nepal and moderate deterioration in Bangladesh. On the other hand, developing countries in the region have witnessed either marginal improvement (in Pakistan) or only a marginal deterioration (in India and Sri Lanka).

In sum, although the estimates indicate that institutional quality in the South Asian region as a whole either deteriorated or improved only marginally in 2008 compared with 1998, the deterioration in the case of LDCs, with a few exceptions, was more pronounced than in the developing countries of the region.

4.3 Supply-side constraints

Implicit in most analyses that focus on market access barriers as major handicaps preventing the LDCs from benefitting from multilateral trade (see, for example, Inama, 2002; Laird and Puri, 2005; UNCTAD and Commonweath Secretariat, 2001; Hoekman, Ng and Olarreaga, 2001; World Bank and IMF Staff, 2001) is the conjecture that the LDCs have an infinite elastic supply response that enables them to capture market for their exports once trade barriers are removed and market access is guaranteed. This also presupposes a 'market-based' response, whereby enterprises in the LDCs are expected to respond swiftly to market opening (see, for example, Pandey, 2006).

This has not happened. Indeed, Pascal Lamy, Trade Commissioner of the EU at the time of offering DFQF market access to the LDCs under the EBA initiative, cautioned: "Duty-free access alone is not enough to enable the poorest countries to benefit from liberalized trade. We need to help them build their capacity to supply goods of export quality". (European Commission, 2000) A number of scholars (e.g. De Vylder, 2007) have echoed these concerns. Even the DTISs – which were prepared as part of the EIF for the LDCs – have emphasized that several supply-side problems represent the biggest constraints on the LDCs' integration into the global economy (IMF and World Bank, 2005: 38).

Adhikari (forthcoming) defines suppy-side constraints as "constraints on domestic productive capacity that limit the ability of a country to produce goods or services for supplying the international market in a competitive manner. Although some of these constraints are due to natural handicaps, the majority of these are owing to governance failure, implying the inability of the government to make optimal provisioning of public goods".

Within policy circles, UNCTAD was one of the first international organizations to raise the issue of supply-side constraints in 1996, as reflected in its least developed countries report for that year. The report states: "supply-side constraints have always been an impediment to development in the LDCs, but their importance has been heightened by globalization and liberalization because of the *increasing premium on the efficient production of traded* *good*". (UNCTAD, 1996: III, emphasis added) Further, the entire LDC report for the year 1999 was dedicated to the issue of building productive capacities and competitiveness, in which the issue of supply-side constraints figured most prominently. The report, without underestimating the salience of market access barriers, noted: "The most pressing development concern of LDCs on the eve of the twenty-first century could be encapsulated as follows: how to address supply-side constraints to enable the countries to produce more competitively for domestic as well as international market". (UNCTAD, 1999: 74) Later, the United Nations Economic and Social Commission for Asia and the Pacific (UNESCAP, 2004) brought this issue into sharper focus in the context of Asian developing economies by focusing primarily on their competitiveness (ibid.: 2). It has become even more relevant today in the context of the heightened competitiveness that is emerging as a global concern (see, for example, Krugman, 1994; Watson, 2005).

An empirical analysis of the aid and trade relationship by Santos-Paulino (2007), using a sample of 17 LDCs and based on data for the period 1970–2001, finds that LDCs' export response to trade liberalization has been relatively limited compared to that of developing countries, primarily due to weaknesses in "domestic productive capacities". This finding is consistent with previous studies that examine constraints on LDCs' export trade (see, for example, Fugazza, 2004; Redding and Venables, 2004). Similarly, a study focusing exclusively on the Pacific island economies finds that if supply-side constraints were removed, the increase in export receipts would be very promising (Ram, Prasad and Duncan, 2005). Apart from these general studies, a specific study focusing on infrastructure and transportation costs, which are major constituents of suppy-side constraints, reveals that "poor infrastructure accounts for 40 percent of the predicted transportation cost for the coastal countries and up to 60 percent for landlocked countries" (Venables and Limao, 2001: 252).

In addition to traditional suppy-side constraints, the emergence of new types of constraints is adding to the burden of LDC exporters. Some of them, such as health, safety and environmental standards, are linked to market access barriers because LDCs lack the necessary infrastructure, legal systems and administrative apparatus to assure the importing countries' authorities of their ability to comply with these standards.[28] And putting them in place would require resources that are often beyond the means of many LDCs. Some authors have suggested that RTAs could help LDCs overcome these constraints mainly because of their transboundary public good nature and the possibility they offer in the pooling of resources and for expertise and for devising a coordinating mechanism to address these issues at the regional level (Maur, 2008).

There are other suppy-side constraints, such as the absence of trade facilitation measures, which are equally costly to overcome despite their unquestionable trade benefits (OECD, 2005; Wilson and Otsuki, 2005). Most RTAs did not include explicit provisions on trade

28 The problems that Nepal faces in exporting honey to Norway are a case in point. Because Nepal does not have a control system on the use of drugs in bees and its official veterinary services lack inspection and certification systems for honey, Nepalese exporters cannot export honey to Norway (Mahato et al., 2004).

facilitation until recently (Moïsé, 2005, cited in Maur, 2008). A study by Bin and Misovicova (2007) suggests that 34 of the 102 RTAs in the Asia-Pacific region now include such provision (cited in Maur, 2008: 16). The institutional set-up of the RTAs, particularly those involving deeper integration, seems well suited for pursuing the trade facilitation reform agenda (ibid.).

Three recent studies have attempted to look at the supply-side constraints confronting South Asian LDCs with a view to considering, among others: prospects for enhancing their competitiveness in the T&C sector (Adhikari and Yamamoto, 2007); prospects for the South Asian countries, including the LDCs, to unleash their export potential (both intraregional and beyond the region) in the T&C sector; and strategies that could be adopted by the Asian LDCs in general to facilitate their export diversification (Raihan et al., 2007). All these studies, which analyse the supply-side constraints faced by two South Asian LDCs – Bangladesh and Nepal – highlight the following binding constraints:

- Inadequate infrastructure within the region in general and among the LDCs in particular for the efficient transportation of goods (see also De, 2005) prevents these countries from establishing a foothold in markets where efficiency of delivery is a key test to determine the sustainability of business relations.[29]
- The lack of human capital with the education and skills necessary to process exports means that despite low wages, South Asian workers are unable to match the level of productivity of workers in other, highly competitive countries (such as China), even in labour-intensive production (Siddiqui, 2007).
- Lack of access to credit hinders the prospects of meeting working capital requirements, expanding business volumes and enhancing investments in capital goods.
- The high cost of inputs resulting from the poor quality of infrastructure and the virtual absence of backward linkages increase the cost of production and thus exports.
- The virtual absence of trade facilitation measures causes delays in the shipment of goods and raises costs, including in the form of unofficial payments for both imports and exports.

The above studies did not quantify the magnitude of the supply-side constraints, and neither did they attempt to compare them with a set of benchmark countries in order to gauge the impact of these constraints. Such comparisons for South Asian countries are attempted here, using the World Bank's Logistic Performance Index (2010) and Trading Across Borders indicators, the latter being part of the World Bank's *Doing Business Report 2010* (table 4.2).

29 In the context of the LDCs, inadequate road links (Afghanistan, Bhutan and Nepal), port facilities (Bangladesh) and shipping and airline infrastructure (Maldives) are of particular concern. As estimated by a recent study (Wilson and Otsuki, 2005), if South Asia's infrastructure capacity could be increased even halfway to the East Asian level, intraregional trade would increase by 60 percent.

Table 4.2: Logistics Performance Index of South Asian countries, 2010 (scores and ranking)

Indicators	South Asian LDCs										South Asian developing countries					
	Afghanistan		Bangladesh		Bhutan		Maldives		Nepal		India		Pakistan		Sri Lanka	
	S	R	S	R	S	R	S	R	S	R	S	R	S	R	S	R
Overall LPI	2.24	143	2.74	79	2.38	128	2.4	125	2.2	147	3.12	47	2.53	110	2.29	137
Customs	2.22	104	2.33	90	2.14	118	2.25	98	2.07	130	2.7	52	2.05	135	1.96	143
Infrastructure	1.87	139	2.49	72	1.83	141	2.16	111	1.8	143	2.91	47	2.08	120	1.88	138
International shipments	2.24	141	2.99	61	2.44	120	2.42	125	2.21	143	3.13	46	2.91	66	2.48	117
Logistics competence	2.09	141	2.44	96	2.24	127	2.29	117	2.07	143	3.16	40	2.28	120	2.09	142
Tracking & tracing	2.37	128	2.64	92	2.54	105	2.42	121	2.26	140	3.14	52	2.64	93	2.23	142
Timeliness	2.61	146	3.46	70	2.99	122	2.83	133	2.74	139	3.61	56	3.08	110	2.98	125

Source: World Bank, 2010b.

Note: The scores range from 1 to 5, with 5 being the highest.

S = Score; R = Rank

Considering 2.5 as the mid-point of the lowest possible overall score (1) and the highest (5), all South Asian LDCs, except Bangladesh, are below average in logistics performance (table 4.4). Overall, Bangladesh's performance is the best and Nepal's is the worst (almost at the bottom of the index). It is interesting to note, however, that Bangladesh, despite being an LDC, has a better LPI than Sri Lanka and Pakistan. India is the best performer in the region, with an overall index of 3.12 and a ranking of 47. South Asian LDCs, apart from Bangladesh, fare poorly on infrastructure, international shipments, logistics competence and timeliness.

Similarly, trading-across-borders indicators, which are another way of measuring trade facilitation indicators, show that South Asian LDCs lag behind the developing countries of the region on a number of counts (table 4.5). Of particular note are the number of documents required and number of days needed for trading imports and exports. These are also reflected in the costs to import and export in the LDCs. It is understandable for a country like Afghanistan, which does not have sound infrastructure in place, to incur the highest costs to export (US$3,350) and import (US$3,000). Afghanistan also ranks the lowest among the countries in the *Doing Business Report 2010* in terms of its trading-across-borders indicators. In the case of Nepal and Bhutan, the costs to import and export are very high – almost three times higher than the least costly exporter (Sri Lanka) and importer (Pakistan) within the region. Although the landlocked status of these countries is partly responsible for this, the lower quality of domestic infrastructure also seems to play a role in increasing their costs of trading across borders. Maldives, being an island country, is in a different situation because its costs to import and export, which incidentally are the same, are significantly lower than those incurred by other countries due to the limited number of days required for trading across borders (table 4.3).

Table 4.3: Trading-across-borders indicators for South Asian countries, 2009

Indicators	South Asian LDCs					South Asian DCs		
	Afghanistan	Bangladesh	Bhutan	Maldives	Nepal	India	Pakistan	Sri Lanka
Doing business – trading across borders (rank of 183)	183	107	153	126	161	97	78	65
No. of documents required for exports	12	6	8	8	9	8	9	8
No. of days required for exports	74	25	38	21	41	17	22	21
Cost to export (US$ per container)	3,350	970	1,210	1,348	1,764	945	611	715
No. of documents required for imports	11	8	11	9	10	9	8	6
No. of days required for imports	77	29	38	20	35	20	18	20
Cost to import (US$ per container)	3,000	1,375	2,140	1,348	1,825	960	680	745

Source: World Bank, *Doing Business Report 2010*.

4.4 Geographical constraints

In regional and international trade, the LDCs with access to the sea, such as Bangladesh and Maldives, are likely to perform better than the landlocked LDCs located far from international or regional market centres. The problems relating to transit trade burdening the three landlocked LDCs in South Asia – Afghanistan, Bhutan and Nepal – reduce their competitiveness due to the increased time and cost of transportation. A landmark study by Faye et al. (2004) shows that transportation costs for landlocked developing countries are, on average, 9 percent higher than those for their maritime counterparts and that they also trade, on average, 50 percent less than the latter due to their dependence on transit-providing countries. The study identifies four types of dependence: dependence on neighbours' infrastructure; dependence on sound cross-border political relations; dependence on neighbours' peace and stability; and dependence on neighbours' administrative practices (ibid.: 31). These are discussed further on in the context of South Asian LDCs, though it should be pointed out that some of the problems relate to extraregional trade rather than regional trade. Nonetheless, these are important issues to consider because trade outside the region provides significant economies of scale and opportunities for learning by doing.

4.4.1 Dependence on infrastructure

Although the quality of infrastructure facilities in India (the transit country for Bhutan and Nepal) and Pakistan (the first-tier transit country for Afghanistan) is better than that of the LDCs, and significant efforts are being made to expand and upgrade them, they are still far inferior to those of their competitors, such as China, in several respects. For example, as illustrated by OECD (2005: 4), as a result of the delays and inefficiencies at Indian ports, Indian companies suffer a 37 percent cost disadvantage in shipping clothing from Mumbai to the United States compared with Shanghai (see also Adhikari and Weeratunge, 2007:186). Even among the LDCs of the region, Nepal has an option to use the Chittagong port in Bangladesh for its exports, but it is heavily constrained by the inefficient operation of that port (IMF, 2007, cited in Adhikari and Weeratunge, 2007:186).

Similarly, as documented by the World Bank (2008:17), both India and Pakistan have extensive rail networks, but their use for transportation of merchandise is quite low. Instead, trucks (which cost more) carry the bulk of inland freight: 60 percent of tons per kilometre in India and 95 percent of tons per kilometre in Pakistan. Even the paved roads that the trucks ply have low geometric standards with widths narrower than 5.5 metres, are built with bitumen macadam, have a relatively rough surface and are poorly maintained. Most roads on the trade corridors are either two lanes and/or recently upgraded to multilane, passing through urban areas with a high flow of traffic, and the trucks have to compete with pedestrians, bicycles, agricultural tractors and non-motorized vehicles, which cause congestion and lead to increased transportation costs (ibid.).

4.4.2 Dependence on sound cross-border political relations

Landlocked countries have to depend on strong political ties with transit countries. "If a landlocked country and its transit neighbour are in conflict, either military or diplomatic, the transit neighbour can easily block borders or adopt regulatory impediments to trade". (Faye et al., 2004: 45) One such example is that of India, the sole transit neighbour for Nepal, imposing an embargo at the border between the two countries in 1989-1990 for political reasons.[30] This caused a massive reduction of Nepal's trade with India and with its other trading partners (ibid.: 46). There are reasons to suspect that the ongoing conflict between Afghanistan and Pakistan could have similar implications for trade between these two countries as well as for regional trade.

Transit countries may not have similar relations with all their landlocked neighbours and, accordingly, tend to use their negotiating power to discriminate between what they consider 'good' and 'bad' neighbours. Faye et al. (2004: 66), for example, show how the difference in the political relations of India with its two northern neighbours – Bhutan and Nepal – has resulted in different outcomes for these landlocked countries. According to them:

- Nepal and Bhutan are unique in the fact that they have only one transit neighbour, India. This implies complete dependence on India for access to the coast, giving India enormous negotiating power. Interestingly, each has a very different political relationship with India. Bhutan has enjoyed a very close working relationship with its southern neighbour and as a result has been granted liberal access to transit. In fact, India allows Bhutanese

30 During this time, Nepal bought arms from China without consulting India, which India claimed was required in accordance with the spirit of the Indo-Nepal Treaty of 1950.

transit trade to be conducted under the supervision of Bhutanese customs, yielding little administrative hassle. In contrast, Nepal's relations with India have frequently been strained, with India often seen to have more influence in the negotiation of treaties and disputes.

Even when there is no direct conflict, landlocked countries are extremely vulnerable to the political vagaries of their neighbours (Faye et al., 2004: 45). Although, as argued by Faye et al. (2004: 45), "there is a legal basis for rights of landlocked transit as outlined in Article125 (1) of the United Nations Convention on the Law of the Sea", this does not mean much because "in practice, this right of access must be agreed upon with the transit neighbour (Article125 (2) and (3)) and is determined by the relationship between the countries". Moreover, Article V of WTO/GATT also provides for similar rights, but this has not been invoked so far, probably due to conflicting interpretations of the provision. Discussions on this issue are taking place at the ongoing Doha Round of trade negotiations of the WTO under the broad rubric of trade facilitation. Whether or not there will be any meaningful outcome will depend significantly on the final outcome of the Doha Round, which itself is in limbo (Adhikari, 2009b).

4.4.3 Dependence on peace and stability

Even when the landlocked countries and their transit neighbour have harmonious relations, peace and stability in the latter are a precondition for the safe movement of goods into the latter's market as well as to other international markets. This problem is not as recurrent in South Asia as it is in some African and Central Asian countries (Faye et al., 2004: 47), but neither is it a negligible one. An example is the bilateral and transit trade between Nepal and India. For instance, when there are strikes in the Kolkata port or political conflicts in the eastern Indian state of Bihar (which is considered a politically volatile state), from where most of the goods trade takes place, Nepalese trade with India as well as with other countries comes to a grinding halt. Another problem, not directly related to peace and stability but related to the fragile political environment of Nepal and neighbouring Indian states, is that whenever elections take place on either side of the border, the borders are sealed, ostensibly to prevent vote rigging. No trade takes place during these periods.

4.4.4 Dependence on administrative practices

Transit countries' transportation management, administrative and customs-related policies are prepared with certain objectives that suit their own socio-economic and political realities, the shaping of which the neighbouring landlocked countries have no role (UNCTAD, 2004). Therefore, traders in such landlocked countries have no choice but to adapt to those formalities, even if they add to the cost of trading across the border.

In the context of Africa, for example, Gupta and Yang (2007: 401) observe that RTAs in general have not generated the expected benefits for the landlocked countries of the region because their coastal neighbours have more often than not created administrative obstacles (customs procedures) in addition to physical ones (roadblocks), resulting in excessively high transit costs. Transit costs can be both official and unofficial. The official costs include customs duties and costs associated with loading and unloading of consignments at the border, while the unofficial costs can be bribes to customs officials. Apart from these costs, which are fairly straightforward, international transit also requires burdensome paperwork and bureaucratic procedures that impose an additional cost burden on exporters (Faye et al., 2004: 47). Border crossings also cause long delays in transit time and, as argued by Faye et al. (2004: 48), "It is regularly noted that the time delays and the variability of time in transit are a greater concern to traders than direct costs, as they hinder the ability to meet delivery contracts without large inventory stocks." This concern is particularly justified in the context of the finding that each day saved in the shipment to goods is equivalent to a 0.8 percent saving on *ad valorem* duty (Hummels, 2001).

In addition to the costs associated with landlockedness, a mountainous terrain can pose another geographical constraint, adding further to the vulnerability of countries like Afghanistan, Bhutan and Nepal, for two main reasons. First, road construction to facilitate relatively cheaper means of transport (i.e. surface transport) is highly cost-intensive. Even within this category, rail transport is cheaper, but Bhutan does not have any domestic rail network, Nepal has a very limited and dilapidated rail line along a minor section of Indian border towns, and Afghanistan has short spur rail lines that link with railways in adjoining countries (World Bank, 2008:17). Therefore, most parts of these countries are linked only by air transport, adding hugely to the cost of trade for exporters. Second, due to the scattered locations of buildings, farmlands and unorganized business establishments, it is not cost-effective to provide utilities such as electricity and telephone connections to export-oriented industries and enterprises. This also adds to their cost of trade, preventing their access to the national market, let alone regional and international markets (Adhikari, 2005).

This is not to suggest that LDCs located in coastal areas are in a particularly advantageous position. Those located far from the major ports, city centres and markets suffer severe cost disadvantages, even if they use their own ports. Further, they may sometimes depend on ports in neighbouring countries if their volumes do not justify enough ship calls (UNCTAD, 2004).

Although Maldives, being an island economy, does not face such a huge cost disadvantage as other landlocked South Asian countries, a diagnostic trade integration study (DTIS) conducted as part of the IF found that transportation costs are a major problem (Government of Maldives, 2006). The major export of Maldives – fish – is a perishable item and the competitiveness of fish exports depends on the ability of the country to transport these products to regional and international markets within a short time span. The country lacks an interchange facility with appropriate infrastructure and amenities to ensure quick and efficient movement of goods from foreign-going ships to domestic boats and vice versa. Another form of swift transportation is airlifting the consignments, which, besides being costly, has not been possible due to limited air connectivity between atolls and international airports and lack of cold storage facilities at the main landing sites (ibid.).

4.5 Growing bilateralism within the region

Even after the launch of SAPTA negotiations, which clearly indicated member countries' intentions to proceed with an RTA, an overwhelming majority of these countries continued to conclude bilateral FTAs among themselves. While FTAs between India and Nepal, and India and Bhutan predate the formation of SAARC, some of the relatively recent ones, such as the Indo-Sri Lanka FTA, the Pakistan-Sri Lanka FTA and the Bangladesh-Bhutan Trade Agreement, seem to be a reaction to the frustration with the slowness of the SAPTA processes. Therefore, as Weerakoon and Thennakoon (2008: 13-14) argue, those countries that were impatient to gain access to important markets within the region and to compete for securing 'first-mover' advantage decided to opt for 'fast-track' liberalization options.

The major impetus for such bilateral trade agreements was provided by the Indo-Sri Lanka FTA, signed in 1998, which opened up markets in a selective but substantial manner. Now that both the countries have shown interest in moving beyond trade in goods by signing a Comprehensive Economic Partnership Agreement, this Agreement is poised to surpass SAFTA on all counts and create disincentives, particularly for Sri Lanka, to engage in negotiations on SAFTA's 'goods only' framework (see also Weerakoon, 2007). Similarly, Sri Lanka signed an FTA with Pakistan in 2002, which has been in operation since 2005. This FTA is modelled on the Indo-Sri Lanka FTA, with a few differences in the concessions provided, depending on the products of export interest and on the political economy factors in each country (ibid.). Discussions are now under way on possible FTAs between Bangladesh and Nepal, Sri Lanka and Bangladesh as well as India and Bangladesh. A World Bank (2006) study suggests there are few, if any, commercial benefits from India signing a bilateral FTA with Bangladesh, however.

The competitive FTA frenzy that has gripped the region has several economic and political implications. Some of these are similar to the ones expressed in the heated debate on multilateralism versus regionalism, which has been discussed extensively elsewhere (see, for example, Kelegama and Adhikari, 2007). They deserve some mention here as well, not least because they need to be situated in a broader theoretical context. These discussions centre around first, the issue of whether the two modes of liberalization (regional versus bilateral) that competitive or complementary in nature, and second, the politics of regional cooperation in South Asia and bilateral trade relations among the countries that have signed FTAs with each other.

4.5.1 Nature of trading arrangements

Akin to the arguments expressed in the largely inconclusive debate on whether regional trade integration is a 'building block' or 'stumbling block' to multilateral trade liberalization, similar arguments can apply to the spate of FTAs within the region. Most studies suggest that bilateral FTAs within South Asia are acting as 'stumbling blocks' to regional trade integration for the following reasons:

Mini spaghetti bowl: Numerous bilateral FTAs with regional trading partners are likely to create a 'mini spaghetti bowl', with overlapping rules governing each bilateral FTA, SAFTA and the WTO. This is akin to the 'spaghetti bowl' phenomenon observed by Bhagwati (1995) in the context of regionalism in general. Added to this is the fact that five countries in the region are also members of another transregional trading arrangement – the BIMSTEC FTA. This will not only complicate trading arrangements within the region but will also dampen the prospects of using trade liberalization as a tool for enhancing the flow of cross-border investments (Weerakoon, 2007).

Hub and spoke pattern: There is a clear 'hub and spoke' pattern emerging within the region, a concept developed by Wonnacott (1990), as discussed earlier in the context of North America. Applied in the context of South Asia, India seems to be emerging as a hub, while some of the other countries, such as Bhutan, Nepal and Sri Lanka (and probably Bangladesh in the near future), are emerging as spokes. One of the major implications of this pattern is the hegemonic role of the hub, which has the power to alter the negotiating dynamics, which raises concern among the spokes. Weaker countries, in particular the LDCs, are at a greater disadvantage when negotiating with a much stronger trading partner, compared with what they might achieve if all the member countries negotiated on a regional basis. This resembles what is currently happening when developing countries (weaker partners) sign bilateral FTAs with powerful industrialized countries, such as the United States, or with groupings such as the EU or the European Free Trade Association (EFTA). They often fall into the trap of making commitments to implement 'WTO-plus' conditions that limit their policy space to address their development needs (Montes and Adhikari, 2005).

Scarce negotiating capital: With scarce negotiating capital at their disposal, particularly in the case of LDCs, each country would be inclined to devote more resources to those agreements that it feels are more beneficial, on balance, to itself. This is bound to have a deleterious impact on SAFTA negotiations, which are becoming less and less attractive for countries that have signed FTAs with India, the largest market in the region.

Trade creation versus trade diversion: Admittedly, there has been some 'trade creation' particularly between India, on the one hand, and Bhutan, Nepal and Sri Lanka on the other, although to a lesser extent between Pakistan and Sri Lanka (Adhikari, 2009a). It is equally important to note, however, that there exists potential for 'trade diversion', although no study focusing on this issue has been conducted so far. For example, if it is cheaper for India to import readymade garments from Nepal – a relatively higher cost source – due to zero-tariff access under the Indo-Nepal FTA, India would not purchase them from Bangladesh, despite the fact that the latter is highly competitive in this sector. This is because Bangladeshi readymade garments would be subject to MFN or SAFTA tariffs to access the Indian market.

4.5.2 Political factors

Political factors relating to a regional FTA in South Asia can be broadly categorized under two subheadings: a) Indo-Pakistan relations; and b) domestic political economy factors, as discussed below.

Indo-Pakistan relations: Rhetoric aside, political relations between these two nuclear rivals have remained sour ever since the creation of SAARC, and there are few, if any, signs of this changing in the near future. Even on the trade front, Pakistan's denial of MFN treatment to India under SAFTA means that trade between these two countries still operates under the bilateral positive list approach. Although the cost of non-cooperation has been well documented,[31] these two countries seem to be attempting to isolate each other from the rest of the region. They seem to be oblivious of the fact that their (in)action is casting a shadow on regional economic cooperation in South Asia.

India is in a relatively advantageous position because of the size of its market as well as its geography. It shares land or sea borders with every other country in the region, except Afghanistan, and happens to be the largest trading partner in the region for all the other countries. Therefore, it is attractive for those countries to conclude a bilateral FTA with India. Pakistan, which is the second largest market in South Asia, seems to be reacting to these developments, for example, by signing its own bilateral FTA with Sri Lanka[32] and expressing a desire to enter into FTAs with other countries in the region as well, notably Bangladesh and Nepal.

Domestic political economy factors: These factors are still strong in most countries in the region, which hinder the prospects of increased trade despite the signing of bilateral FTAs. For example, the fact that a vocal manufacturers' lobby in Nepal has an interest in exploiting the opportunities offered by an (potential) FTA with India is reflected in the way Nepal's trade agreement with India was crafted in the first place. Those investors interested in making quick profits invested in sectors such as zinc oxide, synthetic yarn, copper wire and vegetable ghee, in which Nepal did not have a comparative advantage. The investors exported their outputs to India, taking advantage of tariff differentials between Nepal and India, and were not concerned about creating value addition in the Nepalese economy. At the same time, small farmers, who are the least organized, have found themselves at a disadvantage due to increased imports of subsidized agricultural products from India.

Another example of the political economy factor at play is that India has been resorting to various types of NTBs to discourage imports from countries such as Nepal and Sri Lanka, thus jeopardizing the predictability of trade relations whenever India is under pressure from its domestic lobby (Adhikari, 2009a).

31 See, for example, CUTS, 1996.

32 It may not just be a reaction; there could be other, equally important factors at play, such as the excellent political and military relations between the two countries.

4.6 Informal trade

The volume of informal trade among South Asian countries has been a matter of extensive debate in the past few years, with various studies estimating substantial volumes of such trade. For example, Sawhney and Kumar (2008: 5) note, "Among certain SAFTA Members, informal trade is rather significant and often greater in value than the official trade reported between countries." For instance, the bilateral unofficial trade (exports plus imports) of India with Bhutan, Nepal, Pakistan and Sri Lanka was estimated to be more than the official trade in the 1990s (Sawhney and Kumar, 2008). Tariff barriers are often cited as the reason for traders to engage in informal trade. However, even after the substantial reduction of tariff barriers between India and Nepal on the one hand, and India and Sri Lanka on the other, informal trade continues to thrive (ibid.: 6).

Several studies have been conducted to quantify the magnitude of the informal trade of India with Bangladesh (World Bank, 2006; Rahman, 2002), Nepal (Karmacharya, 2004; Taneja et al., 2001), Pakistan (Khan et al., 2005) and Sri Lanka (Taneja et al., 2001) and to assess its policy implications. This subsection therefore focuses on examining the trends in informal trade between two LDCs – Bangladesh and Nepal – and India.

Informal trade between Bangladesh and India has been prevalent ever since Bangladesh became independent (World Bank, 2006: 57). This trade is essentially of two kinds, with or without the connivance of informal traders and government officials on either side of the border. The first category is called 'technical' smuggling. This type of informal trade mainly takes place in large quantities, mostly by trucks, through the formal legal customs and other channels, though it involves "explicitly illegal practices such as under-invoicing, misclassification, and bribery of customs and other officials" (ibid.). Another category of informal trade usually involves large numbers of local people individually transporting small quantities, often just as head loads or by rickshaw. In Bangladesh, this type of informal trade is sometimes called 'bootleg' smuggling (ibid.).

According to a survey conducted in 2002-2003, Bangladesh's imports of smuggled items from India totalled more than US$500 million, which was roughly 40 percent of imports through formal channels during the same year (World Bank, 2006: 58) (table 4.4).

The above example shows a one-way flow of informal merchandise exports (i.e. from India to Bangladesh). Estimates of informal merchandise exports from Bangladesh to India were not available. Nonetheless a study that has tried to quantify the size of informal services exports from India to Bangladesh estimates that in 1998/99, some US$100 million worth of medical and educational services exports went from Bangladesh to India (Rahman, 2002).

To gauge the magnitude of the informal trade between India and Nepal, which share a porous border, two survey-based studies were conducted, one in each country. Those studies found that the magnitude of informal trade between these two countries was between 38 and 103 percent of the formal trade (table 4.5). Although there are several reasons for traders to choose the informal route, the major ones, apart from evading duty payments (which is normally the prime motive), include lower transaction costs, avoiding paperwork and/or procedural delays, lower bribes and prompt realization of payments (Karmacharya, 2004: 375).

Table 4.4: Bangladesh's imports from India in 2002/03: Recorded plus survey-based estimates of informal trade

Modes of import	US$ million	Percent of total
Recorded: land border	580	34
Recorded: sea and air	535	31
Recorded: back-to-back letter of credit	95	6
Total recorded imports	1,210	70
Bootleg: land border	237	14
'Technical' smuggling (land)	185	11
'Technical' smuggling (sea)	90	5
Total unrecorded imports	512	30
Total imports	1,722	100

Source: World Bank, 2006.

Table 4.5: Summary estimates of formal and informal trade between India and Nepal, 2000-2001 (US$ million)

Indian territory	Exports (X)	Imports (M)	X + M	X – M
Formal	141	255	396	-114
Informal	180	228	408	-48
Informal as a percentage of formal trade	128%	89%	103%	54%
Nepalese territory	**Exports (X)**	**Imports (M)**	**X + M**	**X – M**
Formal	614	359	973	-255
Informal	211	157	368	-54
Informal as a percentage of formal trade	34%	44%	38%	21%

Source: Karmacharya, 2004.

The major implications of these webs of bilateral informal trade taking place among South Asian countries are as follows. First, there is a significant loss of revenue for the respective governments. Second, because informal trade transactions are not recorded in the official statistics of any of the countries concerned, it is difficult to gauge the impact of trade reform measures and to prepare strategies and positions for trade negotiations. Third, due to entrenched vested interests and political economy factors associated with informal trade, reform measures are extremely difficult to initiate, implement and sustain. Finally, it is suspected that due to the involvement of criminal elements in informal trade deals, the criminalization of trading activities, with attendant social and political problems, has become deeply rooted in South Asian societies.

4.7 Political economy constraints

Although political economy factors affecting trade policy are not endemic to South Asia, these are, nonetheless, major constraints on trade expansion within the region. In this subsection, due to limited information available, we present the case studies of only two countries — Bangladesh, which is an LDC, and India, which is a developing country.

4.7.1 Case study of Bangladesh

Some authors argue that the trade liberalization measures undertaken by Bangladesh have not significantly contributed to an export-growth nexus because exports make only a limited contribution to GDP growth (Razzaque, 2008b: 54-5). This is attributed to the considerably low level of local value-added content in the country's export products, particularly readymade garments, which, as alluded to earlier, account for an overwhelming majority of Bangladeshi exports. Bangladesh's huge reliance on imported inputs for producing readymade garments is also explained by the fact that the share of domestic value added as a percentage of exports has increased only marginally, from 4.4 percent in 1991 to 8 percent in 2003 (Razzaque, 2008b: 55).

This seemingly dismal increase in domestic value added notwithstanding, the contribution to domestic value added should be seen at a disaggregated level to get a better picture. Bangladesh exports two types of garments – woven and knit. It has significantly increased the percentage of local inputs in the knitted sector, but the limited increase in the woven sector remains a cause for concern (Raihan, Adhikari and Adhikari, 2007). This has also hampered Bangladesh's potential to utilize the Generalized System of Preferences facility granted by the EU through the EBA initiative. To comply with the stringent ROO under the EBA, Bangladesh, like other beneficiaries of this preference, has to meet a 'double transformation' requirement in order to be eligible to export to the EU. Although Bangladesh is allowed to make use of the SAARC cumulation rule, which means that fabrics and accessories manufactured in any other SAARC country (including India) would be considered equivalent to domestically sourced inputs, its exports of woven garments under the EBA have been limited.

The textile industry in Bangladesh, which has significant political clout, seems to have convinced the Government to prevent Bangladeshi readymade garment manufacturers from using the relatively more competitive Indian textiles as inputs for their export processing (see, for example, Adhikari, forthcoming). As suggested by some, Bangladeshi textile manufacturers have persuaded the Government to prevent the import of textiles from India through the land route, which is the least costly route due to the geographic proximity of the two countries.[33] Although the real motive of the Government is unclear, it is possibly seeking to promote local value added in the woven garment sector by protecting its textile industry. It also seems that Bangladesh is seeking to achieve backward integration of the garment industry by developing its domestic textile sector, contrary to the advice of various international institutions, such as the WTO (2006), the World Bank (2006) and the IMF (2007). The Government's restrictions on imports of Indian textiles have undoubtedly prevented Bangladeshi garment exporters, which use textiles as their major inputs, from enhancing their competitiveness in both global and regional markets, although the latter accounts for only a marginal share of those exports.

4.7.2 Case study of India

As mentioned earlier, India is the major market for South Asian LDCs. Despite occasional leniency shown by India as a diplomatic gesture, it remains one of the most protected markets, difficult for them to access (except for Bhutan with which India shares an extremely cordial relationship). Bangladesh has tried to access Indian markets for its exports to reduce its trade deficits with the latter, but success has been limited at best.

In the case study of Bangladesh, we have highlighted the nature of NTBs imposed by Bangladesh on imports of textile fabrics from India. However, trade barriers on the Indian side are no less pernicious. For example, India protects its T&C sector with high tariffs as well as specific duties, and most of the products in this sector are included in India's sensitive list (Adhikari and Weeratunge, 2007). In addition, some agricultural products, which at least in theory could be exported from Bangladesh to India, are protected by NTBs, such as monopoly importing rights being given to state trading enterprises and tariff-rate quotas (World Bank, 2006).

Turning to Indo-Nepal trade relations, another interesting aspect of the political economy of trade protection emerges. The Indo-Nepal Trade Treaty signed in 1996 initially provided a major boost to exports from Nepal. However, after the Treaty was implemented and its impacts began to be felt in certain sectors, some vested interests in India started to protest against the liberal provisions of the Treaty. Because the Treaty is supposed to be reviewed every five years, it had become clear by 2001 that the Indian authorities were unlikely to renew it without making substantive revisions to some of the more liberal provisions. Faye et al. (2004: 46) note that between 2001 and 2002 , "India instituted significant trade restrictions on Nepal during the negotiation of [the] bilateral trade agreement. These restrictions were alleged to have been instituted to extract concessions in negotiations." The Treaty was eventually renewed in 2002 but not without revisions incorporating the following restrictive conditions:

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33 The control of illegal and smuggling activities on or near the land border customs posts was said to be the primary reason for the ban. Although this ban was lifted, with effect from December 2005 for 100 percent of export-oriented industries (World Bank, 2006), it was lately reimposed (Adhikari, forthcoming). The clout of the textile lobby is such that in 2009 it prevailed on the Government not to accept regional cumulation rules to qualify for duty-free exports to the EU market under the EBA (Harun, 2010: 282).

- Stringent ROO requiring Nepalese exporters to fulfil the twin criteria of 30 percent value addition and changes in tariff headings for the products to be eligible for preferential market access.
- Tariff-rate quotas for four major products of export interest to Nepal, with zero duty treatment provided for the following in-quota items: vegetable ghee (100,000 tons), acrylic yarn (10,000 tons), copper (10,000 tons) and zinc oxide (2,500 tons); and MFN duty for any exports above these thresholds.
- Requirement for Nepal to submit the criteria applied for ROO on an annual basis.
- Clear specification of safeguard clauses that define 'injury' with a much more convenient trigger mechanism for the imposition of a safeguard duty over and above the normal tariff.[34]

After these provisions, particularly the first three, were enforced, Nepal, as mentioned in the previous chapter, witnessed a significant reduction in the value of exports of vegetable ghee and zinc oxide to India. While the export values of both these products have fallen to nil since 2009/10, the fall in exports of zinc oxide can be singularly attributed to the imposition of a quantitative restriction. In the case of vegetable ghee, yet another reason caused the exports to plunge, as discussed further on (see also figure 4.1). The last provision listed above, however, has not contributed to reducing Nepalese exports to India because the provision has not been invoked so far. Nevertheless, risk of its invocation and the unpredictability associated with it persist.

Additionally in the Nepalese side is not without fault. Although Nepal does not impose NTBs on Indian products, the imposition of various para-tariffs is quite common.[35] Of the five para-tariffs applied by Nepal, the agricultural development fee (ADF) is particularly targeted at Indian products because it does not apply to imports to which MFN tariffs apply. However, due to the Nepalese commitment at the time of its accession to the WTO to phase out all the other duties and charges, Nepal has started reducing them, and the ADF was accordingly reduced from its previous 10 percent to 5 percent since the fiscal year 2007/08. Moreover, the the budget announcement for the fiscal year 2009/10 has also scrapped the local development fee (LDF), with effect from 16 July 2009 (Adhikari, 2009a).

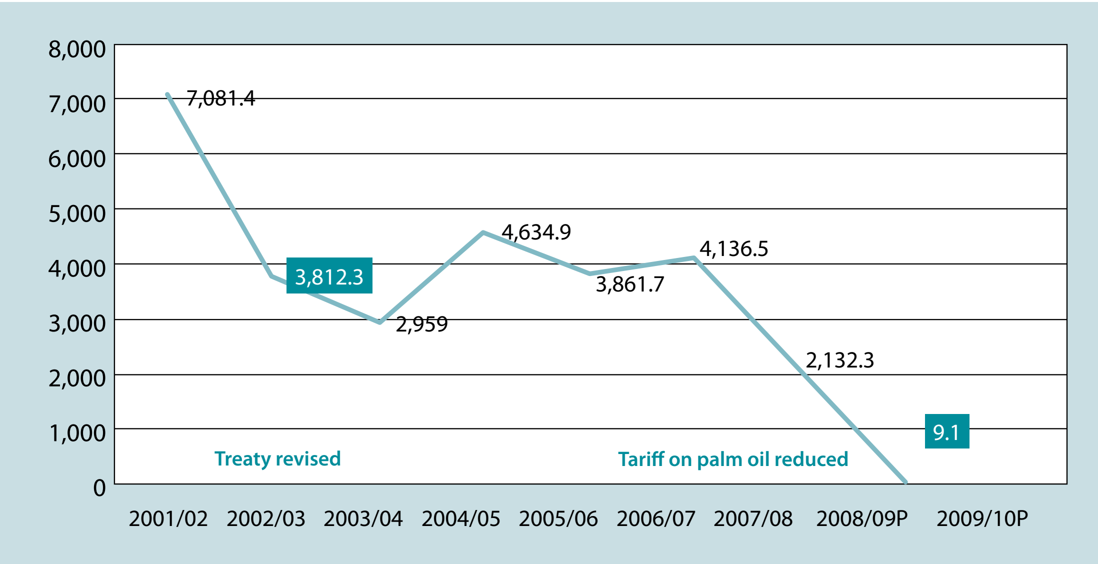
Following a 2009 decision of the Government of India to reduce its tariff on palm oil, which is the raw material for the production of vegetable ghee, Nepalese exports of vegetable ghee to India have fallen, from a peak of 7.08 billion Nepalese rupees in 2001/02 to nil in the first eight months of 2010 (figure 4.1). The figure shows that when the Indo-Nepal Trade Treaty was revised in 2002 and quotas imposed, the impact was immediate. Although exports

34 It is important to note that the safeguard provisions specified in the original 1996 trade treaty could be invoked only when there was as an 'import surge'. Because 'import surge' was defined in a much broader manner and was subject to an 'injury test', it was difficult to prove that injury had actually taken place (see Karmacharya, 2004: 283, for further details).

35 Nepal used to impose para-tariff barriers in the form of: a) an agriculture development fee; b) a local development fee; c) special duty; d) a cigarette and alcohol fee; and e) a cigarette and alcohol control fee (Adhikari, 2003).

of vegetable ghee increased temporarily for three years beginning 2004/05, they started declining from 2006/07. And when the tariff on palm oil was reduced in 2008/09, exports fell by more than 99 percent and eventually tapered off completely.

Figure 4.1: Nepal's vegetable ghee exports to India, 2001/02–2009/10 (Nepalese rupees million)



Source: Ministry of Finance, Government of Nepal, *Economic Survey* (various issues) and Nepal Rastra Bank, *Recent Economic Situation* (various issues).

Although the issue of investment was not discussed earlier, it is pertinent to point out that firms that invested significantly in the manufacture of those products on which trade restrictions have now been imposed have either been compelled to scale down their operations or close their factories. While making such investments, they had a legitimate expectation that market access opportunities provided by India would remain in place. This is no longer the case. The impact has been much more severe on the vegetable ghee industry in Nepal, in which several factories are under threat of closure. This will not only have a major economic impact on Nepal but also the human development consequences due to the ensuing job losses, which could be severe.

The recently revised Indo-Nepal Treaty (in effect since October 2009) has been extended to seven years. It includes some provisions aimed at addressing Nepal's concerns over the imposition of NTBs and para-tariff barriers. This may not provide a major boost to Nepal's exports to India, not least because the provisions aimed at helping Nepal enhance its exports to India are yet to be fully implemented. Consequently, there is continued scepticism about the real intent of the revised Treaty.[36] One of the fundamental issues is that while bilateral FTAs are intended to be permanent agreements, providing an option for any party to exit from them by serving a formal notice of six months to one year to the other party, the

36 See, for example, Kharel, 2009a.

intention behind providing for a fixed duration of the Treaty, to be revised at a particular interval, is not clear. Due to the unpredictability associated with the possibility of major revisions being made to the Treaty, as occurred in 2002, investors may be reluctant to make long-term investments in Nepal that target the Indian market. This only encourages 'fly by night' investors, which is neither desirable for the long-term growth of an LDC like Nepal, nor likely to promote local value addition in the economy (Adhikari, 2009a). As a result, it represents a lost opportunity for promoting employment, poverty alleviation and human development.

Chapter 5

Assessment of existing measures to integrate the LDCs into SAFTA

5.1 Introduction

Given the economic vulnerability of South Asian LDCs and their limited capacity to harness the potential benefits from regional trade liberalization, they have not been able to integrate their economies into SAFTA in a beneficial manner. For such integration to occur, they need special measures, some of which are already being undertaken. Although some of those measures are applicable to all South Asian countries (such as the establishment of a regional body for standardization and accreditation), others are designed specifically for the LDCs (such as S&D provisions within SAFTA). Moreover, some other initiatives, aptly dubbed subregional cooperation frameworks, are under way that aim to provide targeted support for helping certain least-developed parts of India as well as three South Asian LDCs: Bangladesh, Bhutan and Nepal. This chapter analyses the nature and contours of such initiatives, with a particular focus on their effectiveness in terms of speeding up the process of regional integration in South Asia in general and enhancing the participation of the LDCs in these processes in particular.

5.2 Conceptual framework

The analysis presented in this chapter is based on a conceptual framework of 'public goods' prepared by Kaul and Mendoza (2003). Our assumption is that regional trade integration is a regional public good, the provisioning of which is dependent on how countries put their resources and expertise together. First, however, it is necessary to understand the concept of public good and the implications of the assumption.

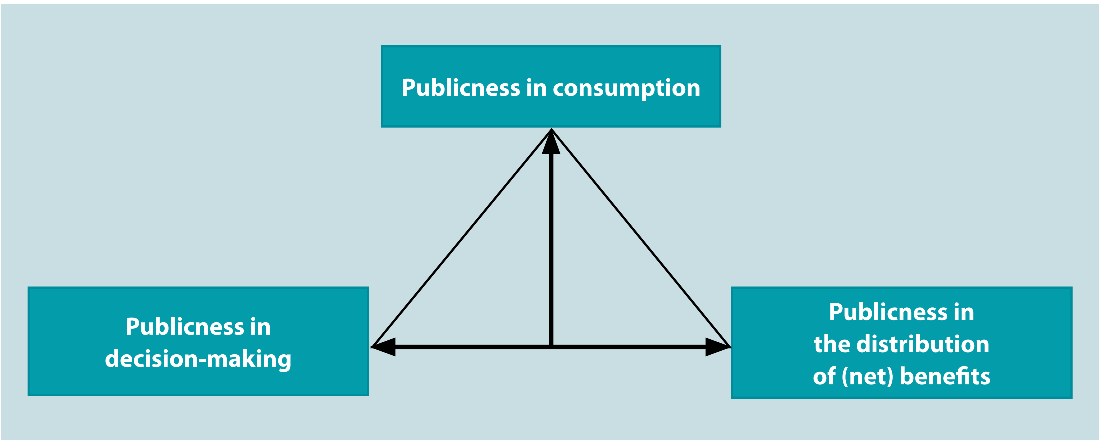
According to Holzinger (2000:1), "Traditionally, two properties of goods are considered as determining their publicness: non-rivalry of consumption and non-excludability from consumption. The necessity for collective provision is based on these two properties, as non-rivalry is the cause of undersupply in the case of public goods and non-excludability the cause of overuse in the case of commons". Therefore, as Holzinger argues, these two properties create an incentive structure for rational agents that prevents the efficient provision of the public goods. There is no doubt that the major factor that undermines the supply response, in particular, is the under-provisioning of public goods. Although public goods can be national, regional and international (Kaul, Grunberg and Stern, 1999), this chapter confines the discussion to regional public goods.

According to Desai (2003: 63), the prevailing theory of national public goods is statist in the sense that the State is expected to finance and make provision for such goods. This is because, as Musgrave (1999) argues, public goods can be efficiently provided by political institutions that are best represented by the State itself. Asserting the primacy of the State as an actor in the supply of public goods, Besley and Ghatak (2006:290) argue that the State has been, and will remain, a central player in the provisioning of public goods "as long as it monopolizes coercion". However, when the question of provisioning of public goods at the regional level arises, it becomes complicated, not least because of the 'collective action' and 'free-rider' problems arising at the level of sovereign State.

Kaul and Mendoza (2003) argue for the need to develop methodologies to systematically assess individual public goods and the public domain as a whole against the following three principle criteria of publicness:

- *Publicness in consumption:* This relates to the non-exclusiveness of the consumption of public goods across individual countries that participate in the SAFTA processes. It should be underpinned by the two other criteria.
- *Publicness in decision-making*: The determination, allocation, distribution pattern and production of public goods should be decided in a participatory manner.
- *Publicness in the distribution of benefits:* This relates to the equity aspects of benefits and tests whether the real benficiaries are able to get a fair share of the net benefits from public goods (figure 5.1).

Figure 5.1: Triangle of publicness



Source: Kaul and Mendoza, 2003: 92.

Although the model presented in figure 5.1 was prepared in a national context, it is equally applicable to the regional context and, by extension, to the context of SAFTA. We now take a closer look at what these elements mean in practice in the context of SAFTA.

5.3 SAFTA as a regional public good

5.3.1 Publicness in consumption

Due to the free-rider problems associated with the provisioning of public goods, countries may tend to avoid contributing towards the provisioning of these goods. This problem can be resolved through the collective efforts of all the countries participating in RTAs (see, for example, Sandler, 2007), such as SAFTA. Given that the countries participating in SAFTA are at different levels of economic development and have different resource endowments and market size, it is futile to argue that they could contribute equally to the provisioning of regional public goods. Therefore, Sandler (2007) states that the concept of aggregation technology, which means "whether the contributions of the individual actors to a common good are additive or not and whether they can be substituted for each another" (Holzinger, 2000:4), should be taken into consideration.

Although States are the major consumers of the public goods provided through RTAs such as SAFTA, other economic actors that have equally important stakes are farmers, business enterprises and consumers. However, when these actors are excluded from the benefits, for example of SAFTA, due to the sensitive lists and NTBs, the arrangement assumes the character of 'club good', as opposed to public good because a significant segment of the stakeholders are excluded from 'consuming' the good.

5.3.2 Publicness in decision-making

Democratic decision-making is a cornerstone of SAFTA and indeed of the SAARC process as a whole, which is epitomized by the consensus-based decision-making process. This aspect of publicness has not been fully utilized by all the members alike, mainly the LDCs, because they have weak negotiating capacity. Although Bangladesh has relatively strong negotiating skills (at least within the LDC group), other LDCs' ability to influence the trade negotiation agenda and outcomes is weak. As discussed, trade negotiating power is partly a function of the size of the market, which Bangladesh seems to have utilized reasonably well. Nepal, despite having the second-largest market among the LDCs in the region, has not made any significant impact on SAFTA negotiations.[37] This is due, among others, to the lack of institutional memory, frequent transfer of well-trained staff from the commerce ministry and the diversion of negotiating capital to promote other forms of trade cooperation, such as the bilateral agreements discussed previously.

Evidence of the mediocre negotiating capacity of the trade negotiators of South Asian LDCs is evident in the S&D provisions of SAFTA. These provisions are contained in three sub paragraphs of Article 3 (Objectives and Principles); four paragraphs of Article 7 (Trade Liberalization Programme); the entire Article 11 (Special and Differential Treatment for the Least Developed Contracting States); and one paragraph of Article 16 (Safeguard Measures). However, as noted in previous chapters, most of these provisions are 'best endeavour' clauses. They are a diplomatic gesture par excellence but meaningless when the LDCs actually want to benefit from them through their enforcement. Among the three sub paragraphs of 'Objectives and Principles', the only effective sub paragraph is the one that states: "The special needs of the Least Developed Contracting States shall be clearly

37 Nepal's negotiating strategy during its accession to the WTO was considered satisfactory (Rajkarnikar, 2005), though that was not only because of the personal calibre of the individuals in the negotiating team but also due to the strong support provided by other stakeholders, including civil society organizations (ibid.).

recognised by adopting concrete preferential measures in their favour on a non-reciprocal basis." Because no deadline has been set for implementing them in the spirit of this sub paragraph, this provision could also turn out to be ineffective in practice (Adhikari, 2004b).

In theory, Article 11 of SAFTA is exclusively devoted to providing S&D treatment to the LDCs. But the non-binding language of this Article renders it rather weak. It uses such wording as: "give special regard to", "to the extent practical", "consider, where practical" and "special consideration shall be given for technical assistance". The last one is particularly noteworthy because it is a statement of intention, not a commitment, and it sets no deadline.

Furthermore, the text of SAFTA appears to offer the LDCs limited S&D treatment, which are similar to those provided in the WTO. It is ironic that those very developing countries that constantly blame industrialized-country members of the WTO for not providing meaningful S&D treatment to the weaker members are themselves demonstrating a reluctance to provide similar treatment to their fellow LDCs within SAFTA (Adhikari, 2004b). Among all S&D provisions contained in the Agreement on SAFTA, only that relating to sensitive lists , providing different sets of commitments towards the LDCs and non-LDCs, has been operationalized so far (table 5.1).

Table 5.1: Sensitive lists under SAFTA

Country	Total number items in the sensitive lists		Coverage of the sensitive lists as a percentage of total HS lines	
	Non-LDCs	LDCs	Non-LDCs	LDCs
Bangladesh	1,254	1,249	24.0	23.9
Bhutan	157	157	3.0	3.0
India	865	744	16.6	14.2
Maldives	671	671	12.8	12.8
Nepal	1,335	1,299	25.6	24.9
Pakistan	1,191	1,191	22.8	22.8
Sri Lanka	1,079	1,079	20.7	20.7

Source: Author's compilation based on the SAARC Secretariat's website.

The real test is whether the non-inclusion of some items in the sensitive lists has resulted in any tangible benefits to the LDCs. In this regard, the available data show that the three years of SAFTA implementation have not helped much in enhancing the exports of LDCs to other countries of the region. As noted, Bhutan's impressive growth of exports to the Indian market and Nepal's growth of exports, albeit slow, to the same market are due to their respective bilateral FTAs with India and not because of SAFTA. The increase in Bangladesh's exports to India, although marginal, can be partly ascribed to SAFTA. Much to the dismay of the LDCs, according to a partial equilibrium (WITS/SMART) model simulation prepared by Raihan (forthcoming), ROO and sensitive lists have emerged as major trade restrictions on LDC exports.

5.3.3 Publicness in distribution of (net) benefits

Because there are several costs involved in any RTA, it is necessary to analyse the net benefits (overall benefits minus overall costs) of any such arrangement to the participating countries and their stakeholders. This would be possible in the context of SAFTA only if all the countries had equal opportunities to obtain benefits from the arrangement and importantly, if there was positive discrimination in favour of the weaker members. A fair distribution of benefits means that the system should ensure equity for all its members and promote distributive justice if the equity is lacking (Adhikari, 2009c). Indeed, this is a key premise upon which regional economic integration programmes, such as those of the EU and ASEAN, are built. This was also highlighted by a report produced by the Coalition for Action on South Asian Cooperation (CASAC) nearly a decade ago, which states:

> "As experience of other regional organisations have [sic] shown that an equitable sharing of benefits of cooperation is the key to success of regionalism, special care must be taken to ensure that the least developed countries can take full advantage of the freeing of trade by other countries. As a means of compensating [for] the cost incurred by them in moving to a free trade regime, it is important to have special elements in their favour" (CASAC, 2001:19)

Given that South Asia as a trading bloc has been fragmented through a web of discriminatory preferences provided to various countries through bilateral trade agreements by the major players in the system, as discussed in chapter VI (Weerakoon, 2007), the potential benefits that could be derived by the weaker countries are substantially reduced. LDCs such as Afghanistan, Bangladesh and Maldives, which have not entered into bilateral FTAs with any developing country in the region so far, are at a considerable disadvantage in terms of market access opportunities compared with LDCs such as Bhutan and Nepal and a developing country such as Sri Lanka, which have bilateral FTAs with at least one developing country in the region.

Another related issue, which was highlighted in the discussion of S&D treatments in the context of SAFTA, is equally important here, not least because such treatment would have helped the LDCs to benefit from equal opportunities and distributive justice. However, the way certain provisions are designed leaves much to be desired. For example, the LDCs are allowed a 10 percent relaxation on the valued-added criteria of 40 percent agreed under the ROO of SAFTA. But several of them have not been able to meet this requirement because of the low level of industrialization and lack of backward linkages/vertical integration. Although ROO are often couched in altrustic terms, such as helping the preference-receiving countries, particularly the LDCs, to industrialize (Adhikari and Yamamoto, 2007), there is no evidence to suggest that stringent ROO have helped any such country in its industrialization efforts (WTO, 2005). Although a genuine fear of trade deflection resulting from more liberal ROO cannot be brushed aside, the trade-restricting effects of stringent ROO cannot be underestimated either.

For example, a study by Raihan (forthcoming) based on a partial equilibrium (WITS/SMART) model, focusing mainly on Nepal's export potential vis-à-vis India in the absence of the stringent ROO requirements imposed under SAFTA, finds that Nepal's exports to India would rise by US$90 million. Because of the ROO, 34 percent of Nepal's potential exports to India remains unrealized. The study singles out ROO and sensitive lists as the two most pernicious trade barriers hindering the prospects of LDCs' trade expansion in South Asia. It further estimates that export expansion from a full implementation of SAFTA, without ROO and the sensitive lists, would amount to about US$1.3 billion, of which the bulk of the gain would accrue to India (US$1.01 billion), though the LDCs would also gain significantly: Bangladesh (by US$33 million), Bhutan (by US$ 21 million) the Maldives (by US$3 million) (table 5.2).

Table 5.2: Simulation results based on trade creation from ROO and sensitive lists under SAFTA (US$ thousand)

From \ To	Bangladesh	Bhutan	India	Maldives	Nepal	Pakistan	Sri Lanka	Total exports
Bangladesh	-	637.69	26,043.61	7.65	918.84	4,750.44	1,198.28	33,556.51
Bhutan	-	-	21,693.89	-	113.13	84.88	0.01	21,891.91
India	350,978.32	40,408.25	-	31,576.28	177,182.61	19,6432.19	218,727.26	1,015,305.01
Maldives	-	-	858.52	-	-	58.81	2,262.29	3,179.62
Nepal	22.08	247.99	89,542.48	2.67	-	699.28	30.63	90,545.13
Pakistan	44,637.39	-	6,0452.46	346.21	691.63	-	7,822.05	113,949.71
Sri Lanka	4,301.66	0.81	2,946.48	16,549.71	973.74	7,040.32	-	31,812.72
Total Imports	399,939.51	41,294.74	201,537.44	48,482.52	179,880.01	209,065.91	230,040.51	-

Source: Raihan, forthcoming.

As discussed in chapter IV, the LDCs in the region have not been able to utilize the market access opportunities offered by SAFTA nor are they likely to do so unless supply-side constraints are removed. SAFTA has done very little to remedy this persistent problem. There was every reason to believe that the special provisions on technical assistance would help the LDCs in a number of ways, including in upgrading their standards-related institutions, construction of warehouses, cold storage facilities and roads and bridges to link small-scale producers with regional markets, implementing customs reforms and training workers and managers to enhance their productivity. Although the Second Meeting of the Sub-Group on Technical Assistance to Least Developed Contracting States, under Article 11 (d) of SAFTA, identified 10 such areas (SAARC, 2005), and some of them do include the above-mentioned wish list, there has been little progress, if any, on the provision of technical assistance so far. This is despite the fact that the European Union's trajectory towards regional economic integration is often touted as a model for economic integration in South Asia. For example, the European Union created a European Regional Development Fund to assist development in the relatively poorer members and late entrants – Greece, Portugal and Spain – and significant transfers were made to these countries to help them address their supply-side constraints, build credible institutions and indeed catch up with the rest of the members (EC-9) (see, for example, Winters, 1997).

The need to provide an opportunity for the LDCs to fully reap the benefits of regional economic integration within South Asia was also aptly highlighted by CASAC (2001). A centrepiece of its recommendation was the "creation of a reasonably large-sized fund for the development of [LDCs'] infrastructure, human resources, export production and diversification of capacity" (p.19).

Finally, the creation of a revenue compensation mechanism, which was considered a unique provision when SAFTA was signed, has turned out to be mere rhetoric. This is not only because of its short-term nature but also because it is not substantial enough to help the LDCs meet their trade adjustment needs (such as compensating the losers from trade liberalization) or generate the funds needed for overcoming supply-side constraints.

5.4 Other initatives

Other measures are also being taken to strengthen the regional trade integration process in South Asia, some of which may not be exclusively applicable to the LDCs. Such measures are broadly divided into two categories: regional initiatives and subregional initiatives.

5.4.1 Regional initiatives

This section analyses the most important regional initiatives, other than those already discussed, in terms of their potential contribution to increasing intraregional trade among South Asian countries in general and the LDCs in particular.

Establishment of a regional centre on human resource development

Human resource development is key to enhancing the productivity of enterprises in the region. Scores of studies have highlighted the significance of human capital, particularly skills enhancement, for productivity improvement and export diversification of the member countries, especially in their move towards the manufacturing of higher value-added items (see, for example, Siddiqui, 2007; Raihan et al., 2007; Adhikari and Yamamoto, 2007; Adhikari and Weeratunge, 2007). However, when the SAARC Human Resources Development Centre was established in 1998, its objective was confined to merely enhancing the "capacity of regional HRD functionaries, policy makers and trainers."[38] Accordingly, most of the research, training and policy advocacy work of the Centre has focused on building the capacity of government officials, with little contribution to building the capacity of managers and workers at the micro level. Although private-sector representatives have also participated in

38 For further details, see centre's website at: www.shrdc-isb.org.pk/ (accessed 3 June 2009).

some of the training programmes organized by the centre, they have mostly been business leaders, representing chambers of industry and commerce rather than manufacturers and traders.

The realization of the need to improve skills at the enterprise level with a view to "increasing competitiveness, higher growth of outputs, exports, employment, and foreign investment"[39] led the centre to commission a study on productivity growth and human resources development in South Asia. The objectives of the study include:

- evaluate the impact of human capital and productivity on economic growth of the SAARC member States;
- assess the impact of human resource development on productivity;
- identify the challenges and opportunities for improving productivity and human resource development in the SAARC member States.[40]

The findings of the study, as emphasized in the concept paper, ideally will help contribute towards formulating a plan of action for improving productivity and human resource development for sustained trade and economic growth in the SAARC member States.[41]

Cooperation on trade facilitation

The benefits of trade faciliation, which entails "improving procedures, especially customs clearance; introducing automation and use of information technology; reducing excessive documentation requirements; addressing lack of transparency in import and export requirements; addressing lack of modernization of and cooperation between customs and other government agencies" (Milner, Morrissey and Zgovu, 2008) are well documented (see, for example, OECD, 2005; Wilson and Otsuki, 2005). Increasingly, both developed and developing countries are realizing that trade facilitation could be instrumental in saving traders considerable difficulties and waste of resources, collectively known as 'trade transaction costs'. Because trade facilitation is instrumental in removing import and export bottlenecks, it has also been referred to as the 'plumbing' of international trade. Another major advantage of trade facilitation is its potential to contribute to greater transparency, reducing corruption and increasing government revenues (Milner, Morrissey and Zgovu,2008).

Several studies have analysed the benefits and costs of trade faciliation measures, comparing these against the costs of maintaining the status quo (see, for example, Wilson and Otsuki, 2005; Swedish Trade Procedure Council and National Board of Trade, 2002). However, one of the most comprehensive examples of relevance to the present discussion is the case of sub-Saharan African countries documented by Gakunu (2003). According to this study, the principal reform measures with respect to trade faciliation include:

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39 For further details, see the 'Concept Paper on Productivity Growth and Human Resources Development in South Asia', prepared by SHRDC, at: www.shrdc-isb.org.pk/ (accessed 3 June 2009).

40 See SHRDC, at: www.shrdc-isb.org.pk/.

41 Ibid.

- reducing excessive documentation requirements;
- addressing the lack of automation and insufficient use of information technology;
- addressing the lack of transparency (i.e. unclear and unspecified) in import and export requirements;
- improving procedures, especially customs clearance, audit-based controls and risk-assessment techniques;
- addressing the lack of modernization of and cooperation between customs and other government agencies, which impede efforts to increase trade flows effectively (Milner, Morrissey and Zgovu, 2008).

Although all these are important reform measures that should be undertaken in South Asia, one of the major initiatives already taken relates to customs cooperations. In 1996, a Group on Customs Cooperation was set up and entrusted with a mandate to harmonize customs rules and regulations, simplify documentation and procedural requirements, upgrade infrastructure facilities and provide training facilities. Several meetings of the group also culminated in the adoption of a Customs Action Plan in August 2004, which aims at:

- maximizing harmonization, simplification and uniform application of customs procedures to facilitate move-ment of goods and passengers;
- ensuring proper application of customs legislation through maximum mutual cooperation and assistance, in particular for combatting commercial fraud and trafficking in illicit drugs;
- improving the working methods and human resources of the member administrations through the efficient use of resources and training of customs personnel.

Despite these objectives, it is difficult to determine to what extent this plan has been helpful in facilitating trade within the region in general and the LDCs in particular, because there is little information available in the public domain on how effectively the plan is being implemented. In the 16th SAARC Summit Declaration, the leaders not only reitered their commitment to accelerate trade facilitation measures but also directed the SAFTA Ministerial Council to work on this issue in a time-bound manner (para 20). It also directed the relevant SAARC bodies to expedite their work in these areas (para 23) (SAARC, 2010).

When the provision of better trade facilitation is impaired by the inherent constraints and incapacity of certain members, but with implications for regional integration efforts as a whole, the regional grouping can help the delivery mechanism through joint assistance. This has undoubtedly been possible in those regional groupings in which developed countries are the major players, such as the EU and APEC. But in the context of South Asia, the example of COMESA – a South-South regional trade arrangement – is more relevant. With COMESA the South African Revenue Services, for instance, provide direct technical assistance to the regional partners (Maur, 2008). This model is worth replicating in South Asia, where customs administrations in developing countries, particularly India and Pakistan, could train customs officials in the LDCs as well as provide technical support for capacity-building in the latter.

Creation of a SAARC standards body

One of the major NTBs that stymie regional trade relates to product standards. These are imposed primarily with the objective of protecting consumers from spurious and unsafe products and fraud and deception. However, due to the non-transparent nature of their application, they can be misused by vested interests because it is often difficult to distinguish between genuinely consumer-friendly standards and protectionist standards (see, for example, Baldwin, 2000). One means of remedying this problem is to create regional standards for products traded both within the region and outside and to implement mutual recognition arrangements on conformity assessment procedures. According to Maur (2008: 986), the requirement of huge sunk costs, the inability to reap the benefits of economies of scale, a lack of technological capabilities and the absence of human resources to handle standards-related tasks make a strong case for setting up a standards-related body or an accreditation body at the regional level. It was probably recognition of this imperative that led the SAARC contracting parties, particularly their standards-related bodies, to recommend the creation of a Standing Group on Standards, Quality Control and Measurement, which was established by the SAARC commerce ministers in May 1998.[42]

After a series of deliberations among the standards-related bodies of the SAARC countries, the South Asian foreign ministers meeting in August 2008, decided to establish a South Asian Regional Standards Organization (SARSO). The objectives of the organization, as provided for in Article 2 of the Agreement establishing it include:

- promote and undertake harmonization of national standards of SAARC member States, with a view to removing the technical barriers to trade and facilitating flow of goods and services
- develop SAARC standards on products of regional/subregional interest
- facilitate capacity-building among the member States in the fields of standardization and conformity assess-ment through training, workshops and seminars
- promote mutual recognition arrangements on conformity assessment procedures among the member States.

The organization, which is to be established in Dhaka, has not yet come into being because all the member governments have yet to ratify the Agreement. Once it is established and the relevant bodies under it are constituted, it is expected to greatly ease the flow of goods within the region. One major problem with this arrangement is that SARSO will deal only with industrial goods, not with agricultural goods, which form the bulk of the products in which the LDCs have a comparative advatange.

5.4.2 Subregional initiatives

The aim of subregional economic cooperation, the result of the collective efforts of the foreign ministries of the countries/areas situated in the eastern part of South Asia, is to provide a boost to economic activities in Bangladesh, Bhutan, the eastern part of India and

42 See SAARC Secretariat website at: www.saarc-sec.org/?t=2.1.7 (accessed 5 June 2009).

Nepal (BBIN). The idea received official acceptance from SAARC when the Ninth Summit of the Heads of State and Government endorsed the South Asian Growth Quadrangle (SAGQ) as a subregional initiative under SAARC.[43]

This subregion is unique in three respects. First, it contains the majority of South Asia's poor,[44] and it accounts for most of South Asia's GDP.[45] Second, this subregion has abundant resources, including human resources, fertile agricultural lands, energy potential, natural resources and port facilities. Finally, this subregion is strategically located between South Asia and South-East Asia.[46] The ADB is its principal development partner and has been supporting the South Asia Sub-regional Economic Cooperation (SASEC) programme – a major programme of the SAGQ – since 2001 through two regional technical assistance projects aimed at better integrating the partners within this subregion and with the rest of South Asia. SASEC working groups have been established in six priority sectors: transport, tourism, trade, investment and private-sector cooperation, energy and power, environment, and information and communications technology (ICT) (ADB, 2006). Although SASEC deals with broader areas of economic cooperation that what is envisaged by SAFTA, trade is unboubtedly a major component of the programme.

The programme is inclusive in the sense that the countries outside the subregional framework can also be included in the relevant working groups if they are interested in participating.[47] It envisages active cooperation between BBIN, SAARC and the BIMSTEC Secretariat for implementation of the projects identified under the programme, and linking these activities with the Greater Mekong Subregion (GMS). The programme is not merely an intra-governmental initiative; it also provides a forum for dialogue with the private sector and other development partners. The technical assistance programme aims at the provision of support to identify and prioritize projects in both South Asian and GMS countries, and particularly at enhancing connectivity in transport, ICT and tourism development. An ADB technical assistance grant of US$1 million is being provided for conducting studies and organizing subregional conferences and meetings. Activities proposed under Phase II of the programme include:

43 See ADB website at: www.adb.org/sasec/assistance.asp (accessed 3 June 2009).

44 The subregion has a population of about 1.16 billion people – 18.4 percent of the world population and 92.8 percent of the South Asian population (ADB, 2006).

45 The subregion's GDP in 2005 was US$543 billion (1.7 percent of world GDP and 86.5 percent of the South Asian GDP (ADB, 2006).

46 See ADB website at: www.adb.org/sasec/about.asp (accessed 3 June 2009).

47 For example, Sri Lanka has been invited to participate in the regional working group on tourism (ADB, at: www.adb.org/sasec/about.asp).

- identifying six major corridors[48] for improving subregional connectivity in terms of physical conditions and operational efficiency;
- removing trade and non-trade barriers identified under the SASEC programme, with a view to facilitating the movement of goods and attracting increased investment from both within and outside the region;
- establishing regional ICT connectivity among BBIN members, with a view to reducing the cost of
communications and enhancing the efficiency of doing business in the subregion;
- harnessing the rich indigenous energy resources in the subregion, with a view to providing benefits to both energy-rich and energy-deficient countries;
- broadening the geographical coverage of the programme to explore providing greater potential benefits, for example, to other South Asian and GMS countries.

The programme seems to have identified the crucial needs of the subregion and is moving in the right direction. However, it could be further strenghtened by also looking into ways of harnessing the trade potential of the rich biodiversity found in the Eastern Himalayan region (ICIMOD, 2006). This aspect has not been covered adequately, although the programme broadly mentions natural resources, the use of which is critical for both sustainable development and human development. Moreover, the programme does not aim to facilitate trade diversification within the subregion and beyond. Pandey (2008:2), who identifies the problems relating to export diversification efforts in Nepal, argues that the "low industrial base, low technological adaptations and innovation at the firm level and low research and development efforts have put a brake on trade diversification efforts and on the movement towards high-technology products. Consequently, the export baskets of most developing countries, including Nepal, continue to be dominated by 'poor goods'".[49] Because this observation is valid for the entire subregion, serious efforts need to be undertaken to strengthen exports of manufactured and high-value products, for which investment in research and development and for unleashing the innovative potential of enterprises is indispensable. The subregional programme, however, neglects these issues.

48 The six corridors are: i) Kathmandu to Birganj/Raxaul to Kolkata/Haldia; ii) Thimphu to Phuentsholing to Siliguri to Kolkata/Haldia; iii) Kathmandu to Khakarbitta, via the Phulbari Corridor, to Banglabandha to Khulna/Monghla or Dhaka/Chittagong; iv) Kolkata via Sunderbhans via the Jamuna and Brahmaputra rivers to Guwahati/Assam; v) Kolkata to Gedes/Darsana to Bangladesh; and vi) Kolkata to Petrapole/Benapole to Jessore to Khulna/Monghla or Dhaka/Chittagong (ADB, at: www.adb.org/sasec/about.asp).

49 According to Haussmann, Hwang and Rodrik (2006), 'poor goods' are those products exported by poor countries where value addition, in particular technological content is low. Such goods have two major characteristics: they are labour-intensive and the skill requirement for manufacturing them is not demanding. And because any country with an abundant supply of labour can manufacture and export them, competition tends to be the highest in these products.

Chapter 6

The trade and human development nexus in the context of SAFTA: The LDC perspective

6.1 Introduction

Trade can be a powerful instrument for economic growth, thereby contributing to a reduction in poverty, which is an important element of human development. However, it is necessary to emphasize at the outset that "greater openness to trade, like economic growth, is not an end in itself: it is a means to expanding human capabilities. Indicators for increased openness – such as export growth and rising trade-to-GDP ratios – are important, but they are not proxies for human development" (UNDP, 2005a: 113). Increased income, particularly as measured by GDP or gross national product, as predicated by mainstream economists as well as modern political philosophers,[50] does not reflect the true picture of human development. Although the human development index – a composite index based on indicators of income, health and education – developed by UNDP makes social criteria the bases for measuring the level of human development of each country at the macro level, there are several other factors that should also be taken into account.

Any discussion on the role of *regional* trade in promoting human development should be informed by the potentially virtuous relationship between these two areas. To the extent that trade contributes to economic growth, it can help countries enhance their human development profiles provided there is a concomitant increase in household spending on health, education and nutrition and that the increased revenue generated through trade is spent by the public sector on building the productive capacity of the economy in general and of people in particular. People can thus infuse dynamism in the economy. Such virtuous relationships, however, are in no way automatic. Therefore, as pointed out by Ranis and Stewart (2005:13), simultaneous investments in both areas (economic growth as well as human development) are necessary to ensure their virtuous relationship.

We hypothesized in the introductory chapter of this paper that, left to its own devices, SAFTA would not contribute to improved human development, particularly among the LDCs of the region. This chapter attempts not only to test this hypothesis but also to discuss how domestic governance issues, particularly those relating to the provision of public goods, are equally vital for enhancing human development.

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50 Sen (2008) is critical of mainstream economists as well as modern political philosophers for their "common attempt to ... see development in the narrow perspective of expansion of the supply of object of convenience (represented, for example, by the gross domestic product or gross national product)" (p. 334). Referring to what modern political philosopher John Rawl calls primary goods (a term he uses for the objective of convenience), Sen further asserts: "The expansion of primary goods is, of course, important, but we have to take into account the variability of the relation between increases in primary goods and the enhancement of basic human freedoms and capabilities" (ibid.).

6.2 Dimensions of human development

Human development is about enlarging people's choices and helping them lead longer and healthier lives by providing them access to opportunities for improving their education, skills, health, nutritional status as well as employment opportunities and livelihood conditions (UNDP, 2006: 15-16). This form of development should therefore be based on people's own capabilities, preferences and choices and cannot be externally driven. For realizing the true human development potential of individuals, it is equally important that they be provided with the opportunity to participate in decision-making processes that affect their access to opportunities.

Viewed in this light, human development is a very broad term, the achievement of which depends not only on the ability of people to assert their rights but also on the responsiveness of governance structures and institutional mechanisms. Therefore, the concept of human development challenges the traditional notion of viewing people as an object of development; it asserts that people should be viewed as a subject of development (UNDP, 2003:23). This makes the human development approach both distinct from and more holistic than other approaches to development. "Development *of* the people builds human capabilities. Development *for* the people translates the benefits of growth into people's lives. And development *by* the people emphasizes that people must actively participate in the processes that shape their lives". (ibid., emphasis added)

6.3 Framework for analysis

For conducting a "human development impact assessment" of SAFTA, particularly in the context of the LDCs, the major question to pose, as is done by the *Regional Trade and Human Development Report* of UNDP (2006: 25) is: "Does human development SEEP to the bottom?", with SEEP standing for sustainability, equity, empowerment and productivity. Therefore, the framework chosen for our analysis considers whether SAFTA a) promotes sustainability of the present generation without compromising the opportunities for future generations to achieve their human development objectives, b) enhances equity within and across nations, c) empowers people to enhance their 'agency' to live more dignified lives and d) provides opportunities for people to raise their productivity. What follows is an elaboration of this framework and testing of the hypothesis.

6.3.1 Sustainability

Sustainability, according to Montes and Memis (2005:14), "is concerned with the durability of social gains and that these gains do not prevent subsequent generations from improving their own welfare". Regional trade integration under SAFTA contributes positively to sustainability in some respects compared with multilateral trade agreements (espoused by the WTO) and transregional trade agreements (e.g. between India and ASEAN). Although entering into an FTA is no guarantee of increased trade, there is a presumption that serious FTAs, particularly those not driven by foreign policy objectives alone and 'trade lite' in nature, aim to increase trade between the participating countries (Sally, 2008), which is likely to contribute positively to human development.

For example, one of the major challenges confronting the world today is the problem of climate change, the implications of which are relatively severe for the low-lying as well as mountainous countries of the region. To the extent that SAFTA contributes to an increase in intraregional trade and such an increase substitutes for the larger share of trade that the countries have at present with countries outside the region, it can contribute to mitigating the impact of climate change. This is because transportation accounts for a sizeable share of global carbon emissions, which can be reduced if the goods are transported from/to neighbouring countries instead of to other parts of the world.

Even if it were argued that mitigation is not the primary concern of the South Asian countries, which historically have had lower levels of carbon emissions than the developed countries, the role of RTAs in facilitating adaptation cannot be denied. Arguably, it is easier to transfer environmentally sound and climate-friendly technologies within the region than from industrialized countries to the region because the latter transfers involve global intellectual property rights issues and have therefore been rather slow even when they occur (Srinivas, 2009:32). One example of intraregional technology transfer is the technology employed for the production of drought-resistant seed varieties, which can be used by all the countries in the region to adapt to the impact of climate change.

However, there are a couple of caveats to the general rule. First, regional trade may have a negative impact on human development "if it does not reflect the real economic, social and environmental costs of production and transport" (UNDP, 2005b: 50; see also UNDP 2005a: 126). If trade between two countries is generated by focusing on artificial comparative advantage in participating countries with little regard to real comparative advantage, such as the export of vegetable ghee from Sri Lanka and Nepal to India, this would foster inefficiencies, contribute very little to value addition, create limited employment opportunities and fail to contribute to either economic growth or human development (UNDP, 2005b). Second, the increased competitiveness of exports generated by neglecting negative social and environmental externalities also contributes very little to human development. Therefore, comparative advantage should truly reflect the social and environmental costs in the exporting countries (ibid.: 50).

The above analysis, which is limited to social and environmental sustainability, does not provide a complete picture. When we talk of sustainability in the context of SAFTA, other factors should also be taken into account. For example, a study by Park (2008) in the context of East Asian RTAs describes a quantitative test of sustainability with respect to four conditions: a) country-specific gains, b) distribution of gains between members, c) global welfare gains and d) Pareto efficiency.[51] He finds that the sustainability of South-East Asian RTAs would be greatly enhanced if ASEAN were to include an expansionary RTA, such as ASEAN+3 or APEC.

51 In economics, Pareto efficiency refers to a situation in which there is no way of improving the condition of one person without making that of another person worse off.

One of the major policy implications for SAFTA is that the goal of regional cooperation should be to ultimately move towards global non-discriminatory trade liberalization and expanded cooperation with other regional trading blocs. This finding is consistent with the assertion made by Kelegama and Adhikari (2002) and SAARC (1999) that SAFTA should look to a future expansion of regional cooperation with other regional groupings, such as the EU, NAFTA and ASEAN.

A sustainability impact assessment also includes determining whether or not benefits derived by people who are dependent on trade (for example, through production, imports, exports and intermediary functions) will be sustained over a longer time horizon. For this, RTA processes and state policies should be directed towards creating mechanisms that would enable countries as well as communities to achieve dynamic comparative advantage and adjust their resources accordingly. These mechanisms are currently non-existent in SAFTA. However, if policy makers and trade negotiators were better able to appreciate these issues, there is no reason why they could not devise the appropriate processes and mechanisms in the future. One example is to preserve the policy space for providing temporary protection to the subsectors that provide livelihoods to the poor and marginalized or in subsectors where their contribution in the total value added is significantly higher than the sector's average.

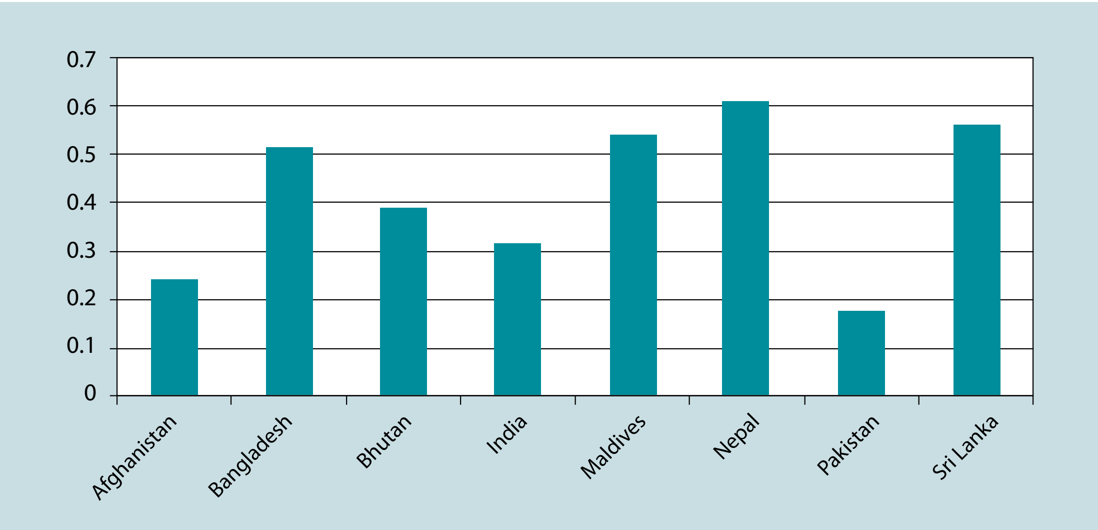
6.3.2 Equity

According to Montes and Memis (2005: 14), "a human development approach to trade recognizes that trade by itself cannot address existing or induced inequities and promotes the search for complementary policies". Ideally, the trading arrangement should be so designed as to ensure equity for all its members. However, if equity is not achievable, given the varied levels of development and supply capacities of the member countries, efforts should be made to promote distributive justice (see, for example, Adhikari, 2009b), not only at the regional level but also at the national level. Global trade patterns are generally perceived as skills-biased, in the sense that they benefit the higher skill categories of workers more than the lower skill categories (Montes and Memis, 2005:13). Although such a pattern is not as evident in regional trade under SAFTA due to largely similar levels of skills and technology among the member countries, the LDCs' predicament might be similar to what they experience when participating in global trade because of their relative lack of skilled human resources and limited access to technology.

Due to the lower level of skills among female workers compared with male workers, the benefits they derive from regional trade integration are fewer and they also suffer a disproportionate burden of adjustment. The female-to-male income ratio (in the organized sector where data are available), which is a proxy indicator of the skill endowment of workers, shows that female workers earn significantly lower income than male workers in South Asia (figure 6.1). Although the female-to-male income ratio is higher in LDCs such as Bangladesh (0.51), Maldives (0.54) and Nepal (0.61) than in developing countries such as India (0.32) and Pakistan (0.18), it is much lower than that of some other developing countries, such as

Mozambique (0.90) Mongolia (0.87), Burundi (0.77) and Colombia (0.71). This suggests that positive discrimination is necessary in South Asian countries in order to reduce the gender-related skill and wage gap and promote equality of access and opportunity to participate in economic activities. The success (or otherwise) of SAFTA in contributing to improved human development in South Asia should be judged, at least in part, by its role in reducing these gaps.

Figure 6.1: Ratio of estimated female to male earnings in South Asian countries, 2007



Source: UNDP, 2009: 188-189.

Given that SAFTA at the regional level, in its current form does not promote equity, this can be remedied if not immediately then in the longer run, by promoting distributive justice. While the Agreement on SAFTA has enshired S&D provisions for the LDCs, as discussed previously, these measures, although much better in content than at the multilateral level, have not moved beyond rhetoric, and can only be considered 'best endeavour' clauses when actually implemented. A meaningful S&D treatment would, *inter alia*, entail: a) relaxed ROO that take into account the level of industrialization of each country; b) a leaner list of sensitive products for the LDCs; and c) a genuine provision for technical assistance along with a revenue compensation mechanism. The latter, in particular, is related to strenghtening the supply capacity of the LDCs, as discussed in an earlier chapter.

Equity is also an important consideration at the national level because it is natural that trade liberalization – or regional integration arrangements for that matter – does not benefit all people equally. For example, it might benefit male skilled workers at the cost of female unskilled workers or the manufacturing sector at the cost of agriculture or the urban population at the cost of the rural population. Therefore, "in order to maximize the welfare gains from trade and to strengthen the political case for participation in trade", according to UNDP (2005a: 124), "it is important that the winners compensate the losers". Given that the market is probably the weakest instrument for overcoming these distributive challenges, it is the responsibility of governments, among others, to: a) maintain policy space during trade negotiation processes in order to smoothen the burden of adjustment; and b) put in place a redistributive mechanism, with a view to compensating the losers. The first issue relates to negotiating capabilities and to the ability of the governments to identify the sectors or subsectors that need genuine protection in an impartial manner. While this is a straightforward proposition, the second issue requires sound judgement on the part of the policy makers taking into account several political economy factors.

Domestic political actors are expected to design policies that strike a balance between the demands of various pressure groups by putting in place an appropriate mechanism to compensate the losers (Rodrik, 1998; Prakash, 2001). This is where Ruggie's (1982) theory of 'embedded liberalism' comes into play. This theory explains the post-World War II bargain that made trade liberalization possible by governments assuaging the potential losers. Empirical evidence points to the 'political effectiveness' of such a bargain (Mayda, O'Rourke and Sinnott, 2007). This theory has been adopted in letter and spirit in the industrialized economies that have significant exposure to foreign trade. In the most open countries, such as Denmark, the Netherlands and Sweden, spending on income transfers has expanded the most, and trade unions have been given considerable voice in designing adjustment mechanisms (Rodrik, 1998). Thus, institutions that promote domestic equity aid the process of creating long-term support for international trade (Prakash, 2001; Mayda, O'Rourke and Sinnott, 2007). However, the ability of States to design the necessary safety nets to compensate the losers is not only a function of the willingness of their governments but also of the availability of resources, which, unfortunately, are scarce in most developing countries and particularly the LDCs. This does not mean that developing countries do not design safety nets to protect the interests of the losers at all. Some relatively less-resourced countries, such as Ecuador and Mongolia, for instance, have put in place mechanisms for compensating those who lose as a consequence of increased trade liberalization (UNDP, 2006). This shows that, given the political will, developing countries can institute safety net programmes when circumstances so dictate.

Such measures are not effectively implemented in most South Asian countries due mainly to resource constraints. There are at least two multilateral initiatives to help these countries in their trade adjustment, namely the Trade Integration Mechanism (TIM) of the IMF and the Aid for Trade (AFT) initiative of the WTO. TIM is exclusively designed to help countries adjust to the unfavourable impacts of trade liberalization only at the multilateral level[52] and is therefore not relevant in the context of an RTA like SAFTA. The other initiative does focus on the regional dimension but seems largely preoccupied with the issue of the provisioning of regional public goods, such as roads, transportation and customs infrastructure, with the expectation that such an investment would facilitate, among others, increased intraregional trade. Although such support is welcome, AFT may have a limited role in helping LDCs overcome the redistributive challenge at the regional level.

52 See Bretton Woods Project at: www.brettonwoodsproject.org/art-51257 (accessed 20 August 2009).

6.3.3 Empowerment

Empowerment is broadly understood as the "capability of the members of society to shape the processes and events that affect their lives" (Montes and Memis, 2005: 11). While paid employment opportunities and the resultant increase in incomes provide people with the means to advance their empowerment, this is not sufficient to guarantee improved human development outcomes. What is required is a set of policies that promote people's empowerment, such as workers' participation in decisions that affect their right to earn a living — whether through collective bargaining or otherwise; farmers' representation on committees established to promote their right to a livelihood; and representation of other stakeholders in shaping trade and industrial policies as well as trade negotiations.

According to conventional belief, which has become almost an axiomatic truth, a democratic polity is sufficient to ensure that the views of the people, who will be affected by any decision, are reflected in policy-making. In the context of South Asia where, for the first time in history, all the countries have democratically elected governments, this has not been the case. This is because of the virtual absence of a consultation culture among policy elites, who believe that they represent the interests of the entire country and tend to sideline the views and opinions of the stakeholders they are meant to represent. The issue of empowerment is particularly salient for the poor and marginalized segments of society, especially women, most of whom are at the receiving end of the socio-political spectrum[53] and have limited opportunities to enhance their agency. This is because "social norms, political culture and public attitudes matter as much as income, economic wealth and overall human development in defining opportunities for women" (UNDP, 2005a: 45).

This issue of empowerment has a bearing not only at the national level but, equally, at the regional level. Although nation States participate in international or regional trade negotiations on an equal footing, at least in the formal sense, some are more equal than others. In trade negotiations, as discussed earlier, sovereign economic power – the ability to provide access to a huge market (carrot) or to foreclose the market (stick) or the ability to provide transit rights (carrot) or to prevent neighbours from using transit facilities (stick) – can hugely influence the outcome of negotiations (see, for example, Adhikari, 2009b). Given that countries in South Asia have varied levels of economic and political power in trade negotiations, which determines the extent of their ability to tilt the balance of negotiated outcomes in their favour, this asymmetry has resulted in outcomes that are less favourable to the smaller countries.

A comparison between the trade figures for 2000 and 2008 reveals that the trade deficits of the LDCs, such as Bangladesh, Bhutan and Nepal vis-à-vis their regional trading partners, have increased significantly (table 6.1). It is pertinent to mention that a trade deficit at the bilateral level, or even at the regional level, may not be cause for concern as long as the countries with these deficits have trade surpluses vis-à-vis countries outside the region.

53 They tend to be ruled, not rulers, having to obey rules though not being involved in setting those rules, and they are obliged to rely on men for access to resources and opportunities.

While this is true to some extent for LDCs such as Bangladesh and Maldives, Bhutan and Nepal have not been as fortunate. It is this asymmetry that needs to be corrected in order to help the LDCs in the region achieve their human development objectives. For this, the LDCs need to be empowered to advance their interests in trade negotiations so that they are not only able to secure access to the markets of developing-country members for products with a relatively higher human development spin-off (such as higher value-added agricultural products or basic manufacturing) but also to enhance their supply capacity in order to take advantage of the market-opening opportunities.

Table 6.1: Regional trade balance of South Asian countries, 2000 and 2008 (US$ million)

Country	2000			2008		
	Exports	Imports	Trade balance	Exports	Imports	Trade balance
Afghanistan	60	169	-109	175	2,331	-2,157
Bangladesh	93	1,050	-957	431	3,916	-3,485
Bhutan	-	-	-	164	171	-7
India	1,820	454	1,366	9,449	2,410	7,039
Maldives	14	90	-76	18	216	-198
Nepal	309	587	-278	881	2,110	-1,229
Pakistan	404	291	113	2,919	1,272	1,647
Sri Lanka	190	707	-517	725	3,213	-2,488

Source: IMF, 2010.

Note: Regarding data for Bhutan, see note to table 2.1.

6.3.4 Productivity

The conventional view of productivity simply looks at the labour-to-output ratio, with a higher ratio indicating a higher level of productivity. This view treats productivity as an end in itself. Seen from the perspective of human development, productivity involves "the raising of human capabilities among members of the society, both as an end in itself and as a means to raise the capability of the society as whole" (Montes and Memis, 2005:12). This view of productivity goes beyond what is predicated by the theory of human capital, which tends to treat human beings as inputs into the production process, not as beneficiaries. Although advances in health, education, skills and other human capabilities are necessary for enhancing productivity, there are at least two conditions that need to be fulfilled to make productivity work for human development. First, the income level of people needs to be increased and they should be protected from income volatility so that households can meet their basic needs, such as food and nutrition security, that are efficiently provided by the households. Second, markets and public institutions should undertake the provisioning of public goods, such as basic health and education, which cannot be provided by individual households (Islam, 2001:7, cited in Montes and Memis, 2005:12).

The role of technology in increasing the total factor productivity of various sectors of the economy has been discussed extensively in the literature, as has the role of trade in the diffusion of technology (see, for example, Schiff and Wang, 2004). The process of technology diffusion or transfer, regardless of the channel through which it occurs, is neither automatic nor costless. Open trade policies are critical for developing countries in attracting technology. But openness is not sufficient; there needs to be absorption capacity and the ability to adapt foreign technologies to local conditions. Both of these are related to capability issues, such as human capital endowment and investment in technology-intensive sectors of the economy (Adhikari, 2004a), as amply demonstrated by East Asian countries. According to Montes and Memis (2005:13), "by providing the foreign exchange and access to capital imports and technology, trade played a critical role in the success of newly industrializing countries in East Asia".

Moreover, a study by Schiff and Wang (2004), which uses industry-level data for technology transfer for three countries (Mexico, Poland and the Republic of Korea), shows strong evidence of regional technology transfer for Mexico and the Republic of Korea and weaker evidence of such transfer for Poland, suggesting that it is much easier to transfer/acquire technology regionally than multilaterally. This underscores the need for regional cooperation on technology transfer.

In the context of South Asia, India is probably the only country in the region that has exhibited an "ascendance of certain manufactured exports differentiated between what used to be the industrial countries' domain, such as automobiles, pharmaceuticals and agricultural implements" (Pitigala, 2005: 22). This evolving comparative advantage is reflected in the fact that India's exports of these highly segmented industrial products to the region account for 36 percent of its total exports to the region, a feat other countries in the region have not achieved, so far (ibid.). Provided there is increased intraregional trade and capability can be enhanced for technology absorption by investing in human capital and in the technology-intensive sectors of the economy, there is considerable scope for productivity improvement within the region.

One of the major considerations that apply to each of these aspects of human development is that these four factors – sustainability, equity, empowerment and productivity – interact closely (Montes and Memis, 2005: 15). However, the domestic structure of economic governance can contribute significantly to improving human development outcomes. For example, empowerment of workers, particularly women working in the export sector, to improve their working conditions helps to promote equity. Better working conditions can in turn enable these workers to engage in greater investment at the household level so as to improve their own productivity as well as that of their family members, including children (ibid.). The role of governance is vital for ensuring that the productive workforce is employed in gainful employment sectors, such that there is movement up the technology ladder and that a policy is in place to empower the workers. Finally, at the level of the society or nation, equity and empowerment can in turn engender productivity and sustainability (ibid.).

The foregoing discussion makes it abundantly clear that SAFTA in its current form does not promote human development, particularly for the LDCs. However, if the regional integration programme is appropriately designed and the domestic system of economic governance overhauled to ensure that human development 'SEEPs', to the bottom and people are made true beneficiaries of regional integration, there is considerable scope for SAFTA to promote human development, as demonstrated by the various examples provided. These are also necessary as well as sufficient conditions for achieving the goal enshrined in the SAARC Charter.

Chapter 7

An agenda for promoting human development in LDCs through SAFTA

7.1 Introduction

If South Asia as a region is to prosper, not only in the face of the challenges unleashed by the processes of globalization but also against the backdrop of the ongoing global economic crisis,[54] increased regional integration is a *sine qua non*. At the same time, according to Sobhan (2001:4), it is important to accord utmost priority to creating "space and opportunity for the weaker members of SAARC to evolve out of their underdeveloped status through the medium of SAARC". The weaker economies, particularly the LDCs, "need to utilize SAARC as a vehicle for their own dynamic expansion and structural transformation, rather than view it as an instrument for their marginalization" (ibid.).

Many studies conducted so far (see, for example, ADB/UNCTAD, 2008; Sawhney and Kumar, 2008) recommend enhancing overall trade and economic cooperation in South Asia and, albeit in passing, addressing concerns relating to LDCs' marginalization. However, the studies do not focus on issues specific to South Asian LDCs and thus do not make substantive proposals beyond the political correctness of suggesting that LDC concerns should be taken on board. To be fair to these studies, their remit was much broader and they were not required to focus exclusively on the South Asian LDCs.

Against this backdrop and rather than repeating the recommendations of the previous studies, unless they are deemed to be absolutely essential for the purpose of this study, this chapter presents an agenda for action based on the summaries and analyses presented in the previous chapters.

7.2 An agenda for action

This section is divided into three parts and discusses measures aimed at addressing: a) market access barries; b) supply-side constraints and competitiveness concerns; and c) expanding the remit of SAFTA.

7.2.1 Removing market access barriers

As discussed in the preceding chapters, market access barriers, both tariffs and NTBs, remain a major issue for the LDCs' integration into SAFTA.

54 The crisis has once again exposed the vulnerability of South Asian countries, which is associated with an overwhelming dependence on the OECD markets and which has consequently made it imperative for the policy makers of the region to redouble their efforts to realize the untapped potential of South-South trade in general and regional trade and economic integration in particular.

Tarff barriers

According to SAFTA, although tariff barriers will eventually have to be reduced to between 0 and 5 percent by the end of 2013 for the exports of the LDCs to the region's developing-country markets, the single most important issue that hinders regional integration efforts and especially the LDCs' participation in regional trade is the sensitive lists maintained by the member countries. This paper does not purport to suggest that sensitive lists are inherently a defective intrument for trade and/or revenue protection. Indeed, sensitive lists may provide much-needed 'policy space' for countries to protect their sensitive sectors for purposes of food security, livelihood security, rural development and the development of small and medium-sized enterprises (SMEs). Therefore, they need to be maintained according to the needs and priorities of each country.

Moreover, some of the countries' sensitive lists account for more than 20 percent of their respective tariff headings and there is no time limit for pruning them within SAFTA (see, for example, Weerakoon and Thennankoon, 2006; Raihan, forthcoming). But there have been two recent developments concerning these lists. First, a committee of experts in 2009 made the decision to require a reduction of the sensitive lists of each country by 20 percent within four years. Second, India has unilaterally revised its sensitive list twice, in 2005 and 2008. As a result, the number of items included in its sensitive list for LDCs has fallen to 480 from the orginal 763, though this represents only 9.5 percent of the total tariff lines of 5,052 items (table 7.1).

Table 7.1: Reduction of India's sensitive list under SAFTA, 2005 and 2008 (at six digit HS code)

		LDCs	Non-LDCs
No. of tariff lines	5,052		
No. of tariff lines in orginal sensitive list (2005)		763	884
No. of tariff lines in revised sensitive list (2005)		744	865
No. of tariff lines in revised sensitive list (2008)		480	868

Source: Rahman, 2010.

Nothwithstanding this unilateral gesture, the LDCs still face formidable tariff barriers in the Indian market. As noted, Pakistan and Sri Lanka have not prepared separate sensitive lists for LDCs. Taking a cue from other South-South RTAs, such as AFTA,[55] it would be useful to reclassify the sensitive lists into three categories: a) temporary exclusion list, not exceeding 10 percent of tariff lines of each member country, with products on the list being phased out over a period of five years; b) sensitive list, not exceeding 5 percent of the respective countries' tariff lines, to be phased out over a period of 10 years; and c) highly sensitive list, not exceeding 5 percent of tariff lines, which could be maintained by each country for

55 See, for example, UNESCAP's *Asia-Pacific Trade and Investment Agreements Database* (AFTA-Goods database) at: www.unescap.org/tid/aptiad/viewagreement.aspx?id=ASEAN%20Goods-AFTA (accessed 3 June 2009).

as long as deemed necessary. Countries would, in any case, have the choice to reduce or eliminate those lists unilaterally should they feel it necessary to accord more favourable treatment to LDC exports.

Non-tariff barriers

Although several NTBs are maintained by SAFTA member countries, this study focuses mainly on two such barriers: ROO and regulatory barriers. These two barriers are not only considered highly pernicious, they also pose a formidable challenge to the LDCs in their efforts to expand exports within the region.

As is evident from the study conducted by Raihan (forthcoming), the use of stringent ROO renders it difficult, if not impossible, for LDCs to enhance their exports within the region. To allay fears of trade deflection, however, it is necessary to maintain some form of ROO. An innovative approach, which needs to be discussed by the commerce ministers of the region, could be to offer LDCs a lower threshold level (around 20 percent) on the value-addition criteria, at least for a period of 10 years, and raise it to the current level after the end of that period. This would not only facilitiate the LDCs' trade expansion but also give them adequate time to develop their industrial base to enable them to source more and more inputs domestically or from within the region (taking advantage of the cumulation rules).

As far as regulatory barriers are concerned, the establishment of SARSO is likely to help the LDCs eventually meet the requirements of standards relating at least to industrial goods through mutual recognition of standards with their trading partners. So far, a similar arrangement has not been made for facilitating trade in agricultural goods and commodities. Therefore, forming a regional body along the lines similar to SARSO, or expanding the scope of that organization to include agricultural products is necessary. At the same time, an LDC Integration Fund (discussed further on) could be established to support food and agricultural standards-related institutions within the LDCs to boost trade in these sectors. The establishment of this fund could also be supported by the AFT intitiative of the WTO (also discussed further on).

If the human development potential of SAFTA is to be enhanced, South Asian countries should agree to a 10-year moratorium on the imposition of NTBs on products of export interest to the LDCs in general and to all SMEs in the member countries because they are the single greatest employers in these countries. Any difficulty in seggregating products exported by SMEs and non-SMEs at the border of the importing countries could be resolved by authorizing a designated authority of the exporting country to certify that the goods being exported are manufactured by SMEs.

7.2.2 Addressing supply-side constraints

Overcoming supply-side constraints in LDCs could help increase their trade prospects in a sustained manner and more effectively than the removal of market access barriers. Removing these constraints would not only help them supply the regional market competitively, it would also provide them with the opportunity to expand their trade in international markets. This in turn could help them gain economies of scale, thereby enhancing their competitiveness in both markets. Some of the crucial measures that need to be urgently implemented to overcome the supply-side constraints of the South Asian LDCs are discussed further on.

Human capital

The SHRDC has begun to appreciate the role of human capital in trade expansion, economic growth and poverty reduction as well as in the achievement of human development objectives. It should develop programmes aimed at expanding its research, training and advocacy efforts without further delay. However, its remit may be limited to training business leaders and managers because its mandate does not cover skills development training for workers at the enterprise level.

It is the principal responsibility of each member country to design and implement programmes aimed at enhancing the skills profiles of its workers and managers. Given the limited return on investment, at least in the initial stage of implementation, LDC governments should take the lead in exploring various avenues to involve the private sector, including through public-private partnerships (see Adhikari and Yamamoto, 2007).

In addition to these efforts at the national level, regional cooperation can be extremely useful. One possibility is that training institutions for skills development in the LDCs could collaborate with training institutions in developing countries through joint ventures or technical cooperation agreements. Another possibility is that floor-level supervisors of enterprises in the LDCs could be given short courses on skills development in specific fields in various South Asian countries. These supervisors, upon their return to their home countries, could then provide training to other workers down the line.

While the short-term measures discussed above have several merits, long-term productivity of workers and managers will depend on sustained investment in tertiary and vocational education at the national level. This should be supplemented by the provision of scholarships for deserving students from the LDCs to enable them to attend universities and vocational training institutions in the developing countries of the region.

Trade facilitation

The efforts initiated by SAARC through the Group on Customs Reform, including the adoption of a Customs Action Plan, are useful initiatives, but they are yet to produce tangible outcomes that could contribute towards the 'plumbing' of regional trade. At the regional level, small initiatives similar to that of the South Asian Revenue Service for building the capacity of its counterparts in COMESA countries could have a noticeable impact. Given its institutional capacity in terms of resources, expertise and skills, the Indian Customs Service is singularly capable of such an undertaking.

Because the primary responsibility for improving the trade facilitation set-up in each country lies with the country itself, a domestic reform agenda is equally vital. While resource constraints may cause difficulties in the implementation of reform measures for many LDCs, policy makers in these countries should recognize two important aspects concerning resources. First, some measures (such as reducing the number of signatures or documentation requirements for exports and imports), which can be executed through a ministerial decision, do not entail any financial burden for the government. For other tasks, such as the computerization of customs offices and hiring and training of staff, which may require some investments, the LDCs can and should seek funding through multilateral facilities, such as the EIF and AFT (see Adhikari and Yamamto, 2007). Moreover, since efforts are under way under the aegis of the ADB, at least in the context of the South Asian Growth Quadrangle, to help the LDCs remedy this problem, they should aim to derive maximum benefits from this initiative. Second, investments to improve trade facilitation produce benefits for both importers and exporters. They also tend to produce much larger economy-wide benefits, which, more often than not, are found to be greater than the benefits derived from the reduction of traditional trade barriers. Therefore, a considerable proportion of the LDC Integration Fund should be spent on improving trade faciliation measures at the regional level.

Research, development and innovation

As noted in chapter V, South Asian countries, with the exception of India, continue to produce and export 'poor goods', and their efforts at export diversification have not yielded satisfactory results. Nor are they targeted at moving up the technology ladder. Barring India, the level of research and development (R&D) in South Asia in general is not encouraging, as measured by industrial value addition, the business sophistication index, the innovation index and the technological readiness index. Two LDCs in the region, Bangladesh and Nepal, which were included in the *Global Competitiveness Report, 2009-2010* of the World Economic Forum (2009), rank much lower than their developing-country neighbours in South Asia (table 7.2).

Table 7.2: Productive capacity, sophistication, innovation and technological readiness in South Asia, 2009–2010 (N=133)

Country	Industrial value addition (% of GDP) 2007	Business sophistication index		Innovation index		Technological readiness index	
		Rank	Score	Rank	Score	Rank	Score
Bangladesh	29	100	3.5	122	2.5	125	2.4
India	29	27	4.8	30	3.7	83	3.3
Nepal	17	126	3.2	130	2.3	132	2.2
Pakistan	27	81	3.8	79	3.0	104	2.9
Sri Lanka	30	42	4.5	46	3.4	85	3.3

Source: World Economic Forum, 2009.

Thus there is a need for concerted efforts, both nationally and regionally, to enhance the technological and innovative capacity of enterprises in these countries. Presently there is no major programme at either level aimed at overcoming these challenges. Moreover, as noted, since even the ADB, which is providing support for the SASEC initiative, has not included R&D as a major support area, efforts need to be initiated primarily at the national level, which then should be supplemented by funding support from the ADB. While resource constraints are a major problem in this area as well, a few innovative approaches could help produce much greater benefits relative to the costs involved.

One way to deal with the resource crunch is to provide tax breaks and other fiscal incentives to private sector enterprises to pool resources for investing in R&D. It should also be possible for the private sector to join hands with national, publicly funded institutions. Provided there is political will to solve this problem, regional efforts should be geared towards providing training to scientists, engineers and other technical profesionals to enhance the technological capabilities of the LDCs as well as ensuring the transfer of technology from developing countries to the LDCs on favourable terms and conditions. Finally, the technical feasibility and economic viability of establishing a regional R&D institution should also be explored.

Transit facilities

Although it is customary to view transit problems as endemic to landlocked countries, in the context of the South Asian LDCs, transit is also a major problem for a coastal country such as Bangladesh. For example, as documented by Rahmatullah (2001: 134), the distance between Dhaka and Lahore (Pakistan) through a direct rail link used to be 2,300 km before the partition of India in 1947. After partition, the removal of the direct rail link (and transit facility) through India has meant that traders are now obliged to take a more circuitous route by rail, sea and rail, thereby increasing the distance to 7,162 km. Similarly, it is no longer possible for goods from Afghanistan to be transported to India via Pakistan's land route (ibid.). Likewise, Nepalese business leaders complain that they are unable to export to the Pakistani market using the land route via India, although, in theory, no barrier exists. For example, tea producers in Nepal, who wanted to export their produce to Pakistan, lobbied the Nepalese and Pakistani governments for the use of Pakistan International Airlines, the only airline that connects Kathmandu with Pakistani cities (earlier Karachi and now Islamabad as well) on concessional terms to help them reduce the costs of airlifting the consignments.[56] Likewise, Nepalese and Bangladeshi traders face insourmountable difficulties while transiting through India, not because any restrictions exist officially but because customs and security officials have the power to create several hurdles (Kharel, 2009b).

56 Based on a personal conversation in August 2004 with Suraj Baidya, the then Vice-president and current Senior Vice-president of the Federation of Nepalese Chamber of Commerce and Industry.

Providing unfettered transit facilities to neighbours, even if purely for trading purposes, is not only an economic (such as leakage of goods into the transit country) but also a political and, to some extent, a national security issue. It is therefore highly contentious, which could be the reason for the absence of any discussion on this issue within SAARC, despite the enormous costs arising from non-cooperation and inaction. Efforts should be made to initiate discussions on the issue of free and unfettered transit for the movement of goods within the region, at least on a trial basis. This could be done by setting some basic ground rules so that security- and leakage-related problems are also addressed. While leakage may not be a major problem in the context of a gradual reduction of trade barriers as envisaged by SAFTA, security concerns should be addressed effectively. If the costs of monitoring compliance with these rules are found to be lower than the benefits accruing to the entire region, it would certainly justify providing unfettered transit rights for the movement of goods (both inward and outward) within and beyond regional boundaries. One such possibility is to institute a system of random checking of consignments to ensure a reasonably good degree of compliance with secruity as well as anti-deflection norms in the least trade restrictive manner possible, without imposing a too much of a cost burdern on regional traders.

Kharel (2009b), for example, makes a strong case for initiating negotiations on a South Asian Transit Arrangement. He argues that the importance of better transit transport facilities is greatest for the landlocked LDCs of the region, but that coastal countries – the traditional 'transit-providers' – also stand to benefit from regional cooperation on transit and transport. For instance, as Rahmatullah (2010), an advocate of a free and unfettered transit regime in South Asia, argues:

> "The shipment of Assam tea to Europe is required to travel 1,400 km to reach Kolkata port along the 'chicken neck', since no agreement exists for India to use the traditional route through Chittagong port, which would be shorter by 60 percent. The southern border of Tripura State is only 75 km from Chittagong port but goods from Agartala are required to travel 1,645 km to reach Kolkata port through the 'chicken neck'. If transport cooperation were there, goods would have traveled only around 400 km across Bangladesh to reach Kolkata". (Rahmatullah 2010: 178)

In exchange for granting India transit rights, Bangladesh could expect India to provide transit facilities to Bhutan and Nepal for their bilateral trade with Bangladesh as well as third-country trade via Bangladeshi sea ports (Kharel, 2009b). Some positive developments that emerged from the visit of the prime minister of Bangladesh to India on 10–13 January 2010, as stated in the joint communiqué, include: a) Bangladesh's agreement to allow the use of Mongla and Chittagong sea ports by India; and b) agreement on the availability of Rohanpur-Singabad broad-gauge railway link for transit to Nepal and Bangladesh's request for a rail transit link to Bhutan (Rahman, 2010).

Although these developments at the bilateral level hold tremendous potential, the Declaration of the 16th SAARC Summit falls far short of the desired commitments at the regional level. The Declaration states that the South Asian leaders "also recognized the importance of development of communication system and transport infrastructure and transit facilities [e]specially for the landlocked countries to promote intra-SAARC trade" (para 23) (SAARC, 2010:4). What is now required is continued advocacy from the private sector and civil society organizations urging the leaders to engage in serious discussions on a South Asian Transit Arrangement.

Funding arrangements

Funding is the single most important cross-cutting issue that needs to be addressed as a matter of priority while discussing regional cooperation for overcoming supply-side contraints. While some of these issues have been discussed already, this section highlights the need for creating a reasonably large-sized LDC Integration Fund (LIF), as envisaged by CASAC (2001:19), to assist the LDCs in these areas. Adhikari (2010) proposes that for the creation and mobilization of such a fund, it is important to first determine its size. Although difficult to quantify without an adequate needs assessment, an indicative portfolio with an annual contribution of US$1.1 billion, calculated at 0.07 percent of the GDP of the SAARC member States could be created. The figure of 0.07 percent is 10 percent of what the United Nations has urged the OECD Development Assistance Committee to contribute in the form of official development assistance (ODA) (see, for example, United Nations, 2002). Similarly, with regard to its financing, the following modalities could be considered.

Core contributions: Three major types of core contributions could be envisaged. First, member States could contribute at least 50 percent of the resource requirements of the LIF, based on their share of intraregional trade. Second, SAARC observers could contribute 25 percent of the total requirement. Third, other multilateral and bilateral donors could contribute another 25 percent of the total requirement. The last two contributions should be in addition to ODA commitments.

Project-based contributions: Because creating regional public goods, such as cross-border road linkages, commu-nication and trade facilitation, are among the priority agendas of the WTO's AFT initiative, it should be possible to acquire seed project-based funding from this source. Examples of existing regional projects include: a multi-donor North-South corridor initiative, jointly implemented by three regional groupings in Southern Africa, an ADB-funded Greater Mekong Subregional Project and the South Asian Sub-regional Economic Cooperation Programme, though the latter is yet to show tangible results.

Although the Sub-group on Technical Assistance to Least Developed Contracting States under Article 11(d) of SAFTA identified 10 areas for addressing the LDCs' supply-side constraints, progress has been minimal. This is partly because of the 'best endeavour' nature of this provision but also because the areas identified do not include 'hardware' components, such as creating infrastructure. To make this initiative effective, it should be regionalized and merged with the proposed LDC Integration Fund. The developing-country members should provide assistance by making direct contributions to the fund, over and above their core contributions.

While the operational modalities could be decided once the funding issue is settled, entrusting a professional management team with responsibility to manage the fund is an essential condition for the successful imple-mentation of projects in priority areas. Adhikari (2010) proposes the following indicative list of priority areas at the regional and national levels, in addition to what has already been identified by the Sub-group on Technical Assistance for funding support under the LIF:

- development of transport corridors to improve regional connectivity and rural access
- construction of a regional grid to facilitate trade in electricity, and a regional pipeline to transport petroleum products
- trade facilitation, particularly modernization of customs administrations
- construction of laboratories and testing facilities
- construction of warehouses and cold storage facilities to enable trade in agricultural products.

7.3 Expanding SAFTA's remit

As discussed in previous chapters, the 'goods-only' framework of SAFTA has come under intense criticism of late (see, for example, Razzaque, 2008a; ADB/UNCTAD, 2008; Sawhney and Kumar, 2008). However, few studies have highlighted the significance of expanding the remit of SAFTA to cover trade in services and rules on cross-border flows of investment. Many of them have hinted that if current bilateral FTAs in the region were to embrace a much broader area of economic cooperation, SAFTA would be less attractive and relevant, at least for those planning to enter into such arrangements.

According to UNDP Institute for Policy Studies of Sri Lanka Conference Statement (2009), "Whilst South Asian economies have undertaken reforms in their respective services sector on a unilateral and multilateral basis, initiatives to support and complement these efforts at the regional level are lagging behind." Because trade in services accounts for a considerable share of overall trade as well as the GDP of most countries of the region, including the LDCs (table 7.3), and because South Asian countries have attained a much higher level of competitiveness in trade in services than in merchandise trade (figure 7.1), significant gains could be derived from an early operationalization of trade in services under SAFTA.

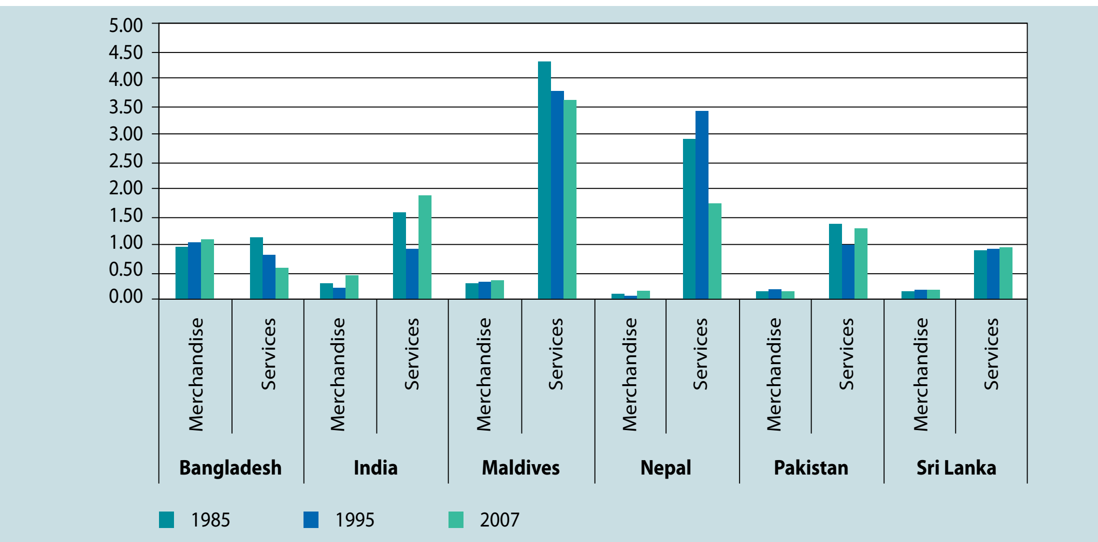
Table 7.3: Status and contribution of commercial services trade in South Asia, 2000–2008

Country	Trade in services (US$ million)		Average annual rate of change (%)				Contribution of trade in services to GDP (%)	Share of trade in services in total trade (%)
	Exports	Imports	Exports	Imports	Exports	Imports		
	2008	2008	2000-2008	2000-2008	2008	2008	2008	2008
Bangladesh	891	3,684	12	13	23	28	5.79	10.44
Bhutan	55	161	13	17	-9	46	15.83	16.88
India	102,562	88,394	–	–	18	26	15.68	27.02
Maldives	687	344	9	16	8	30	81.79	37.50
Nepal	494	840	2	20	46	70	10.58	22.78
Pakistan	2,393	9,079	8	–	8	8	6.82	15.48
Sri Lanka	1,982	2,967	10	8	13	16	12.16	18.09

Source: WTO, 2009.

As suggested by Chanda (2010:15), South Asia's growing competitiveness in services is illustrated by revealed comparative advantage (RCA) indices for services vis-à-vis merchandise for the region. Figure 7.1 shows that in 2007, while the RCA index in merchandise fell to below 1 in almost all the countries in the region, the RCA index for services was more than 2 in Maldives and Nepal, about 2 in India, more than 1 in Pakistan and close to 1 in Sri Lanka. This trend is bolstered by the region's growing trade in services. While South Asia achieved a compound annual growth rate (CAGR) of 23.5 percent in services exports between 2001 and 2007, it achieved a CAGR of 13.6 percent in services imports – both higher than the world average (ibid.).

Figure 7.1: Trends in revealed comparative advantage indices for merchandise and services in South Asian countries, 1985, 1995 and 2007



Source: Chanda 2010:17, based on UNCTAD, *Handbook of Statistics* database.

Even if RCA indices across regions are compared, South Asia emerges as one of only two developing-country regions that experienced an increase in the RCA index for services between 1985 and 2007. It is also the region that has experienced the largest increase in this index during this period (ibid.). For a sector that is experiencing rapid growth in trade, growing participation in world markets and rising competitiveness, there is tremendous potential for intraregional trade as well.

Realizing the significance of the services sector, a Ministerial Council in Dhaka in April 2006 mandated the COE to examine the possibility of including trade in services in SAFTA and commissioned a study to provide recommendations to this end (Bhatta, 2006). After the submission of the report and deliberations in the COE on the benefits and costs of including services within SAFTA, and subsequent to the SAFTA Ministerial Council's decision during its meeting in New Delhi in March 2008 to commence negotiations on this issue, participate in the 15th SAARC Summit in Colombo in August 2008 declared:

> "The Heads of State or Government expressed satisfaction at the conclusion of the Study on Trade in Services and welcomed the decision of SAFTA Ministerial Council to commence negotiation on the Framework Agreement on Trade in Services". (SAARC Secretariat, 2008)

The study on services not only underscored the importance of the services sector to the SAARC economies but also listed some sectors of high priority, as identified by national studies, including tourism, transport, IT, energy, health, education and financial services. The study also proposed a 'positive list' approach to negotiations to enable progressive, sequential liberalization, including some S&D treatment for the LDCs, as recognized by SAFTA (Jayasekera, 2009). The COE, which was tasked to prepare a framework agreement on services, met four times and reached a broad understanding on guidelines as well as a time frame for negotiations, using the WTO's sector classification as the basis. The COE also agreed on progressive liberalization as per Article V of the WTO's General Agreement on Trade in Services (GATS), whereby a 'positive list' approach would be followed on a request-and-offer basis (ibid.).

Following repeated delays, the COE finally managed to complete the draft of the SAFAS in time for signing during the 16th SAARC Summit in Thimpu, Bhutan, in April 2010. This is indeed a welcomed development, but what is now required of the individual member countries is to resist the mercantilist urge and undertake meaningful liberalization commitments while making *minimal* 'carve outs' for sensitive sectors that are crucial for promoting human development objectives.

Despite a number of positive contributions expected from the liberalization of services within SAFTA, there are a few challenges that need to be carefully analysed and necessary safeguards that need to be created so as to address the human development issues and concerns associated with the impending liberalization. One such issue is that of accessibility by the poor and marginalized segments of society to the services provided by foreign enterprises should the prices of those services increase because of a 'profit-push' by such enterprises (Bhatta, 2006). Another issue is the weak regulatory capacity of various countries in the region, in particular the LDCs, for ensuring standards and adherence to rules (Zaman, 2008). Third, because of a lack of data and analysis on trade in services, it is difficult, if not impossible, for trade negotiators and stakeholders to gauge the impact of the opening up of certain sectors or subsectors (ibid.). Fourth, due to assymetry in the trade potential of services within the region, with India being the single largest player and other countries making a minuscule contribution to the global trade in services, the other countries might be wary of India taking the lion's share of the benefits from the liberalization of services (Chanda, 2010).

Meanwhile, as suggested by Chanda (2010), South Asian countries other than India should convert what is currently viewed as an assymetry into opportunity by harnessing the potential of a services trade and investment nexus. Thus, they should allow service providers from developing countries, such as India, Pakistan and Sri Lanka, to deliver services through a commercial presence (mode 3 of GATS). It is equally important that the developing countries provide meaningful S&D treatment to the LDCs by making commitments to liberalize the sectors and modes of export interest to the LDCs and by helping them strenghthen their domestic regulatory capabilities. At the same time, a regional equivalence agreement, whereby every SAARC country recognizes the qualifications of the nationals of all its regional partners, is also vital to enable the free movement of natural persons (mode 4 of GATS).

Another area in which SAARC countries and stakeholders alike have shown interest is the possibility of an agreement on investment protection and promotion. While cross-border investments have been taking place in the region, efforts towards increasing them and protecting them from confiscation and appropriation are key to expanding economic opportunities for South Asian countries, in particular the LDCs. While mode 3 of services delivery under GATS – which all the COE members agreed to as the model in drafting the SAFAS – deals with cross-border movements of investment for the provisioning of services, the contours of the investment framework for the production and supply of goods have to be prepared.

Although intraregional flows of investment have increased in recent years due mainly to the BTAs that India has signed with Bhutan, Nepal and Sri Lanka, the region falls far short of harnessing the full potential of the trade-investment nexus (table 7.4). Nepal is the only country in the region that has received a substantial share (47 percent) of FDI from within the region, but that is from only one country, India, in 2006/07. Prior to that, it had received FDI from all the countries in the region except Maldives. However, since Nepal does not receive much investment from anywhere else in the world because of the deteriorating investment climate in the country, the large share of FDI from India does not reflect a large amount in absolute terms. Indian investment in Sri Lanka is not significant in percentage terms, but in absolute terms it is higher than its investment in Nepal. According to Bhusnurmath (2009), India's cumulative FDI in Sri Lanka reached US$170 million in 2006. In contrast, Nepal's FDI receipts have been extremely limited and volatile (UNCTAD, 2009: 447).

The share of intraregional FDI inflows in total inflows of SAARC countries is very low at present (table 7.4), but this could change if the region made sufficient efforts to utilize regional trade integration as an instrument for increasing the flow of intraregional FDI. According to the ADB (2008), foreign investors globally do not consider South Asia an attractive destination for investment due to the inherent difficulties associated with doing business in the region. Bhusnurmath (2009) is of the view that shallow regional integration is a major deterrent to increased intraregional investment flows, partly because SAFTA, limited as it is, does not include investment within its scope.

Table 7.4: Share of intraregional FDI inflows of total FDI inflows (%)

	India		Bangladesh		Nepal		Pakistan		Sri Lanka
Country	2001/03	2006/07	1995/06	2005/06	Up to 2006	2006/07	2001/05	2006/08	2006
India	-	-	0.620	0.540	40.710	46.600	0.001	0.002	6.200
Bangladesh	-	-	-	-	0.750	-	0.050	0.100	0.180
Pakistan	-	-	1.400	1.870	0.470	-	-	-	0.600
Nepal	-	-	-	-	-	-	-	-	-
Sri Lanka	0.009	0.014	0.230	0.410	0.130	-	-	-	-
Bhutan	-	-	0.005	-	0.010	-	-	-	-
Maldives	0.008	0.009	0.000	-	0.000	-	-	-	-
Share of South Asia	0.017	0.023	2.250	2.820	41.800	46.600	0.060	0.102	7.000

Source: Bhusnurmath, 2009.

Note: The table does not provide data on investments received by Bhutan and Maldives from the region, although India has made
substantial investments in hydro electricity generation in Bhutan and in luxury resorts in Maldives. Similarly, intraregional investment figures for Afghanistan, both inward and outward, are not available.

During the 15th SAARC Summit, the Heads of State and Government directed that the Draft Agreement on Investment Promotion and Protection be finalized early and that the SAARC Arbitration Council be operationalized to achieve further economic integration. However, it appears that, given the preoccupation of the COE members with the finalization of the draft on a services agreement, very limited efforts have been made towards drafting an investment promotion and protection agreement. The 16th SAARC Summit mentioned the issue of investment only in passing by emphasizing "the need to strengthen the role of private sector in regional initiatives through appropriate mechanisms including through public-private partnership as well as the need for greater intra-SAARC investment promotion efforts" (para 22).[57] This would mean that investment promotion efforts will remain mainly a private sector-driven exercise, with limited commitments by the governments to conclude a binding agreement in this area.

57 See: www.saarc-sec.org/userfiles/16thSummit-Declaration29April10.pdf

Chapter 8

Conclusions

As one of the least integrated regions in the world, South Asia faces enormous challenges, both in terms of deriving the potential benefits of broader economic cooperation and in addressing human development issues. These challenges are even more profound for the LDCs of the region, which suffer from several structural weaknesses, have a narrow export base and are unable to take advantage of the limited market-access opportunities provided by SAFTA due to supply-side constraints.

The study reflected in this has analysed two hypotheses. First, despite the political rhetoric, the process of regional trade integration taking place in South Asia under SAFTA is indifferent, if not inimical, to the LDCs' interests. Second, the modalities and pace of regional trade integration under SAFTA do not sufficiently take into account the human development objectives identified by and included in the SAARC Charter. Thus, SAFTA, in its present form, cannot contribute to improved human development, particularly in the LDCs of the region.

Based on a survey of existing literature, this study finds that, if economic theory and the empirical analyses conducted so far are any guide, the weaker economies in the region, particularly the LDCs, will lose out from SAFTA. If the Agreement is limited to goods and if other areas of cooperation are not explored, the prospects for trade and economic growth of the LDCs are not encouraging.

An assessment of SAFTA from the LDCs' perspective reveals that their inability to penetrate the largest market in the region – that of India – is a major problem for these weak and vulnerable economies. This is mainly ascribed to the lack of predictability of market access in India. The problem is further compounded by the bilateral trade and economic cooperation arrangements signed or to be signed by India with countries/economic groupings outside the region. These arrangements are likely to result in preference erosion for the LDCs, which so far have been enjoying some preferential market access in India. An additional cause of preference erosion for them stems from India unilaterally providing DFQF to all the LDCs in the world, although the magnitude of those concessions is limited to 94 percent of tariff lines.

The analysis reveals a number of problems confronting the LDCs that prevent their better integration into SAFTA. They are handicapped by structural constraints, such as a high level of export concentration and thus economic vulnerability to external shocks; geographic constraints, such as landlockedness (e.g. Afghanistan, Bhutan and Nepal) and remoteness (Maldives); and supply-side constraints, such as inadequate infrastructure, lack of human capital, limited access to credit and the virtual absence of trade facilitation measures. Their ability to derive benefits from regional trade is further impeded by the prevalence of a large proportion of informal trade – which dampens their prospects of generating additional revenue and improving governance – and by the web of bilateral FTAs within the region.

Based on a conceptual framework for public goods developed by Kaul and Mendoza (2003), this study has argued that SAFTA, as it currently stands, does not fit into the framework of a 'regional public good' which should be the *raison d'être* of a regional integration arrangement of this kind. This is mainly due to a lack of 'publicness' in the distribution of benefits. The analysis of the real and perceived benefits of various regional and subregional initiatives taken so far to better integrate the South Asian LDCs reveals that these initiatives are far from adequate. The problem is further exacerbated by the lack of political will and severe resource constraints, which impede the effectiveness of these initiatives in promoting LDCs' meaningful integration within the RTA.

The analysis of the trade and human development nexus within the region and in the context of the LDCs, clearly reveals that SAFTA, in its current form, does not promote human development, particularly in the LDCs. However, if the regional integration programme is appropriately designed and national systems of economic governance overhauled to ensure that they help promote equity, empowerment, productivity and sustainability, and if people are made the true beneficiaries of regional integration, there is ample scope for SAFTA to promote human development. These are necessary as well as sufficient conditions for achieving the goal enshrined in the SAARC Charter, which should be the touchstone for evaluating the success of SAFTA.

The seemingly depressing picture presented by this study need not remain so, provided serious thought is given to harnessing the potential of SAFTA or a broader regional economic cooperation arrangement for the benefit of the LDCs and especially for furthering the human development objectives of all the member countries. To realize this objective, efforts are required on three fronts: removing market access barriers, overcoming supply-side constraints and expanding the remit of SAFTA. The developing countries of the region need to give priority to reducing the size of their sensitive lists and removing NTBs on products of export interest to the LDCs and particularly of interest to SMEs. Similarly, regional cooperation on infrastructure development, development of human capital, provisioning of efficient transit facilities, improved trade facilitation and research, development and innovation will go a long way towards realizing the true potential of SAFTA. Finally, SAFTA needs to be expanded to include liberalization of services and protection and promotion of investment. This is because the LDCs in the region have a limited comparative advantage in the goods sector. At the 16th SAARC Summit, tremendous progress was made towards reaching agreement on the liberalization of services but the issue of investment has not yet received the attention it deserves. Yet it is an area that is crucial to successful economic integration in the region.

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