2 TRADE INTEGRATION BETWEEN PAKISTAN AND INDIA

Pakistan and India are the two most populous and largest economies in the South Asian region. Being the dominant constituents of SAARC, both have a great potential for intra-regional trade. Presently, trade between Pakistan and India is taking place through three channels. The formal trade, through official means is marginal; illegal trade takes place through smuggling via porous Indo-Pak land borders and through Afghanistan; trade also takes place through third countries. These include mainly Dubai and Singapore, which are free ports and accommodate legal agents of traders from both India and Pakistan.

Structure of Trade

Official Trade

To date, the magnitude of official trade between Pakistan and India remains negligible compared to their respective global trade volume and neither country falls in the category of top ten trading partners of each other. This is partly due to their history of being relatively closed economies, but more importantly, past political frictions have influenced their mutual trade relations. The share of India's foreign trade in its GDP has increased steadily since the early 1990s, but has remained low at 31 percent until 2003, whereas Pakistan's trade openness stood at 38 percent in 2003. The average trade openness for South Asia was 65 percent in 2003,[1] much below the openness of other regions. For instance, trade openness of ASEAN countries averaged 144 percent in 2003.[2] Moreover, South Asia remains the least integrated regions in the world. Intra-regional trade amounts to only one percent of South Asia's GDP in 2003 compared to 3.5 percent to 4 percent of regional GDP in Latin America, Sub-Saharan Africa, and East Asia and 9 percent of regional GDP in Europe and Central Asia. Intra-regional trade (as a percent of total regional exports) among SAARC countries is less than 5 percent, while it is 73 percent in APEC, 61 percent in the European Union (EU), 57

[1] Simple average: Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka.
[2] IMF Country Report, Pakistan: December, 2004.

percent in the North American Free Trade Area (NAFTA) and 23 percent in the Association of South-East Asian Nations (ASEAN).[3]

As for bilateral trade, Pakistan's total merchandise trade with India (imports plus exports) contributed a meager 3 percent (on average) of the overall trade during the last five years ending 2004-05.The share of India in Pakistan's total exports remained less than one percent, whereas in total imports, it fluctuated within a narrow range of 1.24 to 2.66 percent **(**see **Table 1).** Similarly, the share of Pakistan in India's total exports averaged 0.45 percent whereas in imports it constituted only 0.11 percent during the period 1999-00 to 2003-04. During FY05, Pakistan accounted for only 0.63 percent of India's total exports worth $79.2 billion to the rest of the world and 0.09 percent of the Indian total imports equivalent to $107.1 billion. Using fixed effects-gravity model of

Table 1: Pakistan's Overall Trade Pattern with India

(Million US$)

Period	Pakistan Exports to India	% Share in Pakistan Total Exports	Pakistan Imports from India	% Share in Pakistan Total Imports	Trade Balance with India
1994-95	41.60	0.51	63.99	0.62	-22.39
1995-96	40.74	0.47	94.50	0.80	-53.76
1996-97	36.13	0.43	204.66	1.72	-168.53
1997-98	88.97	1.03	153.41	1.52	-64.45
1998-99	174.72	2.25	145.60	1.54	29.12
1999-00	53.65	0.63	127.35	1.24	-73.70
2000-01	55.40	0.60	235.09	2.19	-179.69
2001-02	49.20	0.54	186.50	1.80	-137.30
2002-03	70.70	0.63	166.50	1.36	-95.80
2003-04	93.70	0.76	382.40	2.45	-288.70
2004-05	288.20	2.00	548.20	2.66	-260.00

Source: Federal Bureau of Statistics

bilateral trade based on 2001 data, a World Bank study has estimated that if normal relations had prevailed, the Indo-Pak trade would have been $1.85 billion,[4] which is substantially higher than the actual trade worth $836 million in FY05.

The growth in bilateral trade over the years has also been dismal and quite volatile. In absolute terms, Pakistan's exports to India (except for FY99) have remained low, and on average have amounted to $70 million per annum during the decade ending FY04, with an average variation of around $41 million. On the other hand, Pakistan imported, on average, $176 million worth of goods from India, resulting in a persistent trade

[3]GEP, World Bank Report, 2005; India Country Note, the World Bank/IMF Annual Meetings, October 2004.

[4] SBP Governor's Speeches: Economic Development in South Asia and the Impact of Globalization, July 2004.

deficit (except in FY99) against Pakistan. The magnitude of trade deficit shot up to $288.7 million in 2003-04 (the highest during the last ten years) mainly due to enhanced imports under the groups of organic chemicals and ores, slag and ashes (+$99.4 million) as well as an exceptional import of raw cotton worth $64.8 million in the wake of low cotton production in FY04. Although exports to India rose sharply to $288.2 million during FY05 but enlarged imports from India worth $548.2 million resulted in a trade deficit of $260.0 million.

The commodity-wise composition of Pakistan's trade with India during the past five years ended FY04 indicated that, on average, over 90 percent of Pakistan's exports to India fall under just six broad categories and accounted for 40 percent of the total number of items exported in a year **(Annexure I).** Out of six, the two broad categories of Pakistan's major exports to India consist of edible fruits and nuts (fresh and dry) and vegetables roots/tubers. Fruits and dry fruits alone contributed, on average, 45 percent of the total exports to India during the last five years. Generally, Pakistan's exports consist of more raw material than finished products. These consists mainly of edible fruits and nuts (fresh/dry), crude vegetable material (vegetables roots/tubers), cotton, other made up textiles articles, woven cloth, and oil seeds (miscellaneous grains and fruits). In addition to these items, some other items have been exported occasionally which include: cereals, sugar and sugar confectionary, wool fine/ coarse and animal hair, petroleum products (mineral fuel/oil/wax and bituminous), natural pearls and other precious stones, tin and articles, etc. The total number of items being exported to India rose from 140 in FY00 to 203 in FY04.

On the other hand, a commodity-wise break-up of Pakistan's imports from India shows that about 49-58 percent of the total number of items imported in a year accounted for about 91 percent of the aggregate value of imports. Pakistan's major imports from India cover a wide range of products. The items in the category of industrial raw material include: organic chemicals, residue/waste from food industry, iron and steel, rubber and plastics articles, tanning and dyeing material, etc. **(Annexure II).** While some other major items cover various kinds of coffee, tea and spices, there have been some occasionally imported items such as sugar and sugar confectionary, cotton, vegetables or oil seeds, pharmaceutical products, etc. Over the years, the share of organic chemicals imports have increased, which on average stood close to one-third of the total imports. However, during the last two years, the import of iron ores, slag and ashes has been quite significant, with a share of 12.2 percent in FY03 and 8.1 percent in FY04. Moreover, the total number of items being imported from India has also increased over time. The import list covered 716 items during FY04, which was 60.2 percent higher than the 447 items on the list in FY00.

Informal Trade

Informal trade generally takes place due to the following reasons: i) restrictions on import of specific items for various reasons such as health issues, religious beliefs or economic reasons; (ii) high tariff barriers or transportation costs which make it cost effective to smuggle the goods in the country; and (iii) imposition of non-tariff barriers such as quantitative restrictions; (iv) weaknesses in the 'rules of origin' resulting in trade routed through a third country; (v) leakages in transit trade; (vi) distortions in domestic policies such as the absence of or relatively low indirect taxes in a country which create an incentive to transport items illegally to neighboring countries.

The smugglers/traders mainly carry out the informal trade between Pakistan and India through the exchange of goods at the Indo-Pakistan border as well as through the misuse of the personal baggage scheme through the "green channel" facilities at international airports or railway stations. Informal trade is also taking place through Afghanistan whereby goods are exported officially from India to Afghanistan and later on smuggled into Pakistan through Peshawar, which lies close to the Pakistan-Afghan border. Indian-made goods which are being smuggled into Pakistan include cosmetics, alcoholic beverages, stainless steel utensils, ayurvedic medicines (30 percent cheaper in India), videotapes, cassettes, confectioneries and cashew nuts, tea and coffee, live animals and spices.[5]

The actual volume of informal trade is unknown, but there are different 'guess estimates' of informal trade between India and Pakistan which vary between $250 million to $2.0 billion annually.[6] The Sustainable Policy and Development Institute (SPDI), Islamabad, estimate the informal trade between Pakistan and India at $545 million in 2005.Total informal exports from Pakistan to India is no more than $10.5 million, consisting mostly of textiles (cloth, bed sheets and prayer mats comprise 90 percent of informal agricultural products. Informal imports from India amounted to $534.5 million in 2005.Six items constitute 80 percent of the total import value, covering, in order of priority, cloth, tires, pharmaceutical and textiles machinery, cosmetics, livestock and medicines.[7] India seems to have lost a share of its informal trade market to China. The extent of informal trade is often used as an indicator of the latent potential that thrives between the two countries. Informal traders in both the countries have developed efficient mechanisms for information flow, risk sharing and risk mitigation. The three important factors viz. quick realization of payments, zero documentation and no procedural delays are contributing to lower transaction costs in the informal channel. The principal implication of this informal trade is that unless the environment of the formal trade improves, informal trade will not only continue to co-exist with formal trade, but it will also impact its potential magnitude in the coming years.

[5] Market Survey; *Pakistan and Gulf Economist*, 11-17 June 2001).
[6] Taneja, 2004; Sangani and Schaffer, 2003; Dhakal, 2004; Kanth, 2002; Mr Riaz Ahmed Tata's Interview with Amitabha, May, 2004.
[7] Khan et al in Naqvi and Schuler, 2006.

Trade through Third Countries

Trade through third countries or circular trade (technically official trade) is mainly conducted through agents operating in free ports like Dubai or Singapore. Circular trade is also taking place through the Central Asian Republics. According to the unofficial estimates, the total size of illegal and circular trade is estimated at around $1 billion, which is much larger than the official trade between the two countries. Exports from India to Pakistan through third country routes include capital goods, textile machinery, dyes and chemicals, iron and ore, spices tannery equipments, machine tools and equipment/spares, cotton fabrics, tires, chemical products, medicines, videotapes, alcoholic beverages, viscose fiber and tea. Informal exports from Pakistan to India cover items such as plastic goods, melamine dinner sets, food items such as edible oil and vegetable ghee, synthetic fibers and some chemical products.[8]

Trade between Pakistan and India via Dubai has the advantage that consignments are not scrutinized as much as those coming directly from either country. The size of circular trade through third countries underlines the potential of flourishing bilateral trade between the two countries. Indian tires, textile machinery, tea, coffee, chemicals and drugs are favored by Pakistanis; however they have to pay inflated prices for these goods coming through indirect routes.

Product Diversification and Spread[9]

Pakistan's overall exports are concentrated in few categories and even within those categories, the textiles and clothing sector currently contributes over 78 percent of the selected 14 categories of exports **(Table 2 & 2a).** Fresh and processed food, miscellaneous manufactures and leather products represent other major categories, reflecting a combined share of about 14 percent in the selected categories. Contrary to this, Indian exports are well diversified across various sectors. The contribution of the textile and the clothing sectors in India is merely 24 percent of the total (selected) exports. Nevertheless, India's exports under these two categories, in absolute terms, are almost double at $12 billion compared to $6.2 billion in case of Pakistan. Other major categories under Indian exports include fresh and processed food (13.8 percent), chemicals (12.3 percent) and basic manufactures (9.5 percent).

The product diversification data indicates that India has better rankings than Pakistan in any of the 14 listed categories **(Table 3).**[10] While the nearest to the Indian

[8] See footnote 2.

[9] The analysis in this section is based on the International Trade Centre, UNCTAD/WTO database, which provides a comparable data series and rankings of the countries based on various categories of performance. The data may not tally with the data reported in other sections for various reasons. For details on ITC database, visit the website of ITC: http://www.intracen.org.

[10] Product diversification is defined in terms of equivalent number of products, which is obtained by taking the inverse of the Hirschman-Herfindal (HH) index. The HH index gives the sum of the squares of the

ranking for Pakistan is only in textiles, it stands way behind in the clothing sector. India's exports in each category are also better diversified than Pakistan and are also ranked better in terms of more contribution to the overall exports (i.e. spread). India has almost more than four times the total number of equivalent products than Pakistan**.** Except for the Misc. Manufacturing and Minerals categories, India has greater numbers of equivalent products than Pakistan. In fact, India is among the top ten countries in terms of product diversification in the Leather Products, Electronic Components and Transport Equipment categories. Even in Textiles, India is among the top 20 countries whereas Pakistan is not.

Table 2: Comparison of Pakistan and Indian Exports (2002)

S.No	Categories	Value of Exports (million US$)		Share in Total Exports	
		India	Pakistan	India	Pakistan
1	Fresh Food	5548	530	10.9	6.6
2	Processed Food	1467	138	2.9	1.7
3	Wood Products	288	0	0.6	0
4	Textiles	6019	4056	11.8	50.6
5	Chemicals	6309	124	12.3	1.5
6	Leather Products	1622	287	3.2	3.6
7	Basic Manufactures	4850	93	9.5	1.2
8	Non-electronic Machinery	1611	0	3.2	0
9	IT and Consumer Electronics	433	0	0.8	0
10	Electronic Components	1105	0	2.2	0
11	Transport Equipment	1253	0	2.5	0
12	Clothing	6031	2201	11.8	27.5
13	Misc. Manufactures	2655	452	5.2	5.6
14	Minerals	11936	133	23.3	1.7
	Total	**51127**	**8015**	**100**	**100**

shares of products in the total export of the cluster. The equivalent number of products is a theoretical value, which represents the number of products of equal size that would lead to the degree of export concentration exactly equal to the observed one. The Spread, on the other hand, is simply the standard deviation of exports in a cluster. Source: ITC background paper on Trade Performance Index.

Table 2a: Comparison of Pakistan and Indian Exports (2002)

S.No	Categories	ITC Rankings					
		Overall Performance		Product Diversification*		Product Spread*	
		India	Pakistan	India	Pakistan	India	Pakistan
1	Fresh Food	21	59	40	46	28	42
2	Processed Food	53	108	55	124	32	96
3	Wood Products	53		22		22	
4	Textiles	14	21	20	31	17	27
5	Chemicals	14	106	25	98	17	80
6	Leather Products	10	28	4	41	7	30
7	Basic Manufactures	23	92	17	52	17	66
8	Non-electronic Machinery	33	-	11	-	11	-
9	IT and Consumer Electronics	47	-	24	-	19	-
10	Electronic Components	35	-	6	-	6	-
11	Transport Equipment	31	-	10	-	16	-
12	Clothing	18	42	45	60	41	54
13	Misc. Manufactures	57	58	100	92	62	70
14	Minerals	56	98	65	47	21	55

Source: International Trade Center Database

* See footnote 3

Pakistan's Existing Trade Policy with India

Pakistan's overall trade policy aims at liberalizing the trade regime in order to integrate its economy into the global trading system, sustaining growth in exports and preparing for a changed international trade scenario with the phasing out of textile quotas by 2005. In this connection, significant efforts have been made during the 1990s. The maximum customs tariff rate on imports, which was 225 percent in 1990-91, was gradually brought down to 30 percent in 2000-01. It was further scaled down to 25 percent in the Federal Budget 2002-03 while the number of tariff slabs were also reduced from five to four, i.e. 25 percent, 20 percent, 10 percent and 5 percent.[11] The trade policy for FY05 envisaged a multi-dimensional effort with a focus to further liberalize and boost exports through bigger volumes of sales covering a wider base of value-added goods and enhanced productivity. This is supported by providing incentives for the proposed special economic zones in the country.

Trade policy with India is being pursued on the basis of the opportunities and threats expected to emerge by trade liberalization between the two countries. In view of its domestic industrial base, Pakistan has adopted a conscious

[11] Annual Report 2000-01 and 2001-02, SBP.

strategy to gradually open trade with India particularly in sectors in which it is not so competitive. In 1983, an India-Pakistan Joint Commission was formed which formally ratified an agreement to foster greater bilateral cooperation in the economic, industrial and commercial fields. As a result, 40 items were allowed for import from India by the private sector, which were later increased to 584 items. While Pakistan allows all kinds of exports to India, it had maintained a positive list of 687 items[12] in 2004-05, which were officially importable from India**.** In pursuance of SAPTA negotiations, the positive list of importable items was expanded by 81 items to a total of 768 items [13](these items correspond to around 1650 items at 8-digit level) and further to 773 items. Most of the new items included in the positive list are in the nature of raw material and chemical items required by the local industry. Items not covered in the list are not permissible for import from India.

On the other hand, India does not impose equivalent formal restrictions on exports to or imports from Pakistan, but other restrictions (e.g. on travel, remittances, customs clearance) are generally believed to have a similar effect, especially as regards imports.[14] In order to protect domestic industries in India, the Indian Ministry of Commerce maintains a list of "Sensitive" consumer goods, imports of which has been regularly monitored with a view to take prompt action to preempt or minimize disruption of local production by competing imports. Products are periodically removed from or added to the list: in February 2004, it consisted of 240 HS products. Domestic production of many of these products is protected by special measures, including high tariffs and also by the use of various non-tariff techniques. To be sold in India about 159 products are

Table 3: Product Diversification - Number of Equivalent Products

	Pakistan	India
Fresh Food	9	11
Processed Food	2	10
Wood Products	-	17
Textiles	30	40
Chemicals	4	32
Leather Products	5	14
Basic Manufactures	14	56
Non-electronic Machinery	-	68
IT and Consumer Electronics	-	8
Electronic Components	-	40
Transport Equipment	-	12
Clothing	13	20
Misc. Manufactures	6	4
Minerals	3	2
All categories	**86**	**334**

Source: ITC

[12] List of items importable from India; Appendix G of Import policy Order 2004-05, Ministry of Commerce, GOP

[13]CBR Order SRO (I)/2004 (Amended as on November 22, 2004); the Daily *Business Recorder* and the Daily *Dawn*; 16 February 2006.

[14] World Bank Report No 29954, September 2004.

required to be certified as meeting Indian quality standards and must obtain an Indian standard mark.

Since the establishment of the South Asian Preferential Trade Arrangement (SAPTA), Pakistan and India have moved gradually towards liberalizing trade with each other. Both the countries have provided significant relief to each other in terms of tariff concessions during the fourth bilateral meeting held on December 3, 2003 under the purview of SAPTA. Pakistan extended concessions to India on 223 items, up to 10 percent on the tariff rates for 2003-04, except for seven items where the depth of concession is 20 percent. The existing tariff on most of these items ranges between a low of 5-20 percent (except 25 percent on four and 30 percent on two items). The total number of items on which Pakistan has so far given concession to India has been extended to around 463 items.[15] India gave Pakistan concessions in the range of 10 percent to 25 percent on tariff rates on 262 items. The existing tariff on almost all these items ranges between 20-30 percent (except 10 percent on only four items), which are substantially higher than the tariff rates offered by Pakistan. Trade between Pakistan and India will be further liberalized when SAFTA will come into force from January 1, 2006. Under the agreed trade liberalization program, Pakistan and India will scale down tariff rates from 25 percent to 20 percent within a time frame of two years, w.e.f. January 2006 (for details, see Section on SAFTA Accord).

Tariff and Non-tariff Trade Barriers in India and Pakistan[16]

Low volumes of trade and low trade integration in India and Pakistan have their roots in their respective trade systems, as both India and Pakistan have relatively restrictive trade regulations. A comparison of the tariff structure of the two countries reflects that Pakistan's tariff structure is far more liberalized than that of India. On the IMF's trade restrictiveness index, India's score of 8 (on a scale from 1 to 10) is markedly higher than the scores of 6 for Pakistan's and 5 for China. Comparatively high trade restrictiveness is partly a regional feature, with the average of South Asian countries at 5.9, compared to an average of all Asian countries of 4.4.Pakistan has the lowest applied average tariff rates of the three large South Asian economies (Bangladesh, India and Pakistan).The average tariff rate in Pakistan stood lower at 14.4 percent in 2005 as compared to 18.9 percent in both India and Bangladesh. Pakistan's average tariff now approaches those of Nepal and Sri Lanka's; the low tariff leaders in South Asia.[17]

In both countries, tariffs have already been reduced from very high levels. India started its trade liberalization in 1991-92, and between that year and 1997-98 the un-

[15] i) SAPTA, Pakistan gives India Duty Relief, South Asian Media Net, June 03, 2004.
ii) KCCI Report 2004 (High-level Trade Delegation Visit to India, February 24 - March 01, 2004).
iii) Pakistan, India agrees on tariff concessions, NEW AGE Business, Dhaka, December 12, 2003.
[16] See footnote 2; Pakistan-India CEO Business Forum Study, January 2005.
[17] Naqvi, Schuler and Richter, 2006.

weighted average tariff was brought down from 128 percent to 34 percent**.** Since 2002-03, the general maximum customs duty was reduced gradually from 35 percent to 25 percent in the Budget 2003-04 and further to 20 percent (30 percent for agricultural products) in January 2004, whereas a previously imposed Special Additional Duty of 4 percent was abolished. However many exceptions were made in several categories of goods, especially in diary products, agricultural products, nuts & fruits, textile products, carpets, etc. An exception in India's trade liberalization efforts is the agricultural tariffs, which at an average of 40.1 percent **(Table 4)** remain substantially higher than non-agricultural tariffs (19.7 percent). India's un-weighted average agricultural tariff in February, 2004 (including tariffs on processed foods) exceeded the latest estimates of agricultural tariffs in all but three (Turkey, South Korea and Morocco) of 124 developed and developing countries.[18]

In Pakistan, trade liberalization started in the 1980s and continued at a cautious pace through the 1990s. The policy was reinforced in 1996-97 with a new comprehensive tariff reduction and simplification program. By 2002-03, the basic maximum tariff was reduced to 25 percent, and currently Pakistan operates with a relatively simple, four-rate structure, i.e.25 percent, 20 percent, 10 percent and 5 percent. The average un-weighted customs duty is 14.9 percent. Pakistan's trade liberalization has included the agricultural sector, where the unweighted average tariff (20.5 percent) is only moderately above the non-agricultural tariff average (13.8 percent).

Table 4: Tariff Structures in India and Pakistan (2003)

in percent

	India	Pakistan
All tariff lines		
Average of customs duties	22.2	14.9
General maximum customs duty*	30	25
Average of customs duties		
Non-agricultural tariffs	19.7	13.8
Agricultural tariffs	40.1	20.5
Percentage of tariff lines subject to higher duties	6.9	1.1
Range of higher ad valorem rates	35-182	40-250

Source: World Bank (2004), Pakistan Central Board of Revenue

(*) In India: 20 percent when excluding agricultural products.

Both India and Pakistan maintain tariff peaks, with basic customs duties exceeding the general maximum rate. Because of the frequent use of specific duties, India has the largest number of tariff peaks in South Asian Region.[19] In India, 6.9 percent of tariff lines exceed the general maximum customs duty of 30 percent, with rates ranging between 35 percent and 182 percent. In addition, 5.3 percent of Indian tariff lines are subject to specific customs duties, in some cases equivalent to 50-100 percent. India's tariff peaks are concentrated in the agricultural, automobile, and textiles and garments sectors. Pakistan, which maintains few tariff peaks (1.1 percent of tariff lines), mainly protects the edible oils and automobile industries, and also imposes high tariffs on

[18] World Bank Report No 29954, 2004.
[19] Tariff lines with basic customs duties, exceeding the general maximum rate.

alcoholic drinks. Despite the efforts to open up for trade, average tariffs of both countries remain relatively high. India's average tariff stands at 22.2 percent in 2003, while Pakistan's is 14.9 percent. These can be viewed in perspective of a developing country median of 11.2 percent.

The imports in India are subject to various types of duties. The highest rate of basic customs duty in India is 70 percent. Some agricultural products are subject to import duties as high as 80 to 150 percent.[20] Other duties include: a) additional customs duties, which are levied on all items imported into India, and are equivalent to the excise duty payable on goods manufactured in India; b) a special duty equivalent to 5 percent of the value of goods on specific articles mentioned in the Customs Act; c) a special additional duty which is levied on all articles with varying rates; d) an additional surcharge which is levied from time to time with varying rates but for most goods equal to 1 percent; e) an educational cess of 2 percent levied on all imports in the 2004 budget. After the goods are landed, imports are also subject to taxes by the Indian states-octroi, local sales tax and local government sales tax and toll tax, etc.

India and Pakistan also employ other types of tariff-like measures. For India, this includes small-scale industry and other exemptions on domestic excise taxes. Moreover, for some products, India applies values other than actual c.i.f. prices as the base for ad valorem import duties, which is done mainly as a preventive measure against under-invoicing, but may at times effectively result in higher tariffs**.** In case of specific duties it must be kept in mind that on the basis of current exchange rate, i.e. Indian Rs 100 = Pak Rs 135.7,[21] the impact of duties will be more pronounced for Pakistan. By contrast, Pakistan has in the past employed "regulatory duties" imposed on top of normal customs duties, to provide extra protection to particular local industries. However, this policy is being phased out, with no new duties being imposed.

Non-tariff Trade Barriers in Pakistan

According to the World Trade Organization's (WTO) definition, non-tariff barriers (NTBs) include all measures, other than tariffs, that are used to protect domestic industry. One of the main principles of GATT is that protection to domestic industries should be through tariffs and not through the imposition of quantitative restrictions and other non-tariff measures. The WTO considers the following to be major NTBs: a) technical regulations and standards; b) import licensing; c) local content requirement/rule of origin issues; d) import by state trading enterprises; e) anti-dumping and countervailing measures; f) customs, shipping and port procedures/regulations; g) technical barriers to trade; and h) government procurement regulations. In addition, the misuse of WTO provisions regarding domestic industry protection (e.g. laws pertaining

[20] Indian Import Duty Regime: High Commission for Pakistan, New Delhi (Information provided by the Ministry of Commerce, GOP).
[21] This exchange rate prevailed on 6 March 2006.

to anti-dumping, countervailing, and safe guard measures, subsidy to agriculture and industry, etc.) also constitute very effective non-tariff barriers.

In the area of non-tariff barriers, one of the most significant obstacles to trade is Pakistan's restriction of imports from India. Although Pakistan has progressively removed all its non-tariff barriers since the 1980s, its imports from India remain restricted to items covered on a positive list. In 1986, Pakistan issued a list of 42 items that were allowed to be imported from India. This list has progressively been extended to 687 items in May 2003, 768 items in November 2004 and further to 773 items in February 2006. In addition, a 2002 Statutory Regulatory Order (SRO) permits the import from India of raw materials which are not produced locally and are required for the production of exports, including approximately an additional 1000 items. The increase in permissible items for import notwithstanding, the positive list approach continues to be a crucial obstacle to imports from India.

Apart from the positive list of imports from India, the remaining restrictions are largely confined to local content programs in the automobile industry. Under these programs, which have to be phased out under the WTO's Trade Related Investment Measures (TRIMs) agreement, import duty reductions are given to individual firms in return for their commitment to incorporate specified amounts of locally produced inputs in their production. In addition, Pakistan employs health and safety-related barriers, including a ban on imports of some second-hand household machinery; used motor vehicles, and some categories of industrial machinery. Pakistan has recently institutionalized anti-dumping procedures under a new anti-dumping law.

Non-tariff Trade Barriers in India

In India, a significant number of non-tariff barriers are in place. Pandey (2004)[22] estimates that the average coverage ratio (which measures the percentage of imports subject to non-tariff barriers) for 1996-97 is 47 for the whole economy and 55 percent for the manufacturing industry. While the protection in the case of consumer goods (65 percent) is quite high relative to the average rate for the whole economy, the protection for intermediate goods (43 percent) and the capital goods (34 percent) are also quite substantial. While import licensing was largely abandoned in 2001, the remaining forms of non-tariff barriers include: requirement of political or security clearance, sampling or customs inspection, requirement of technical/standard certification, labeling and marking rules, packaging rules specification and local content/rule of origin schemes, etc. Government-mandated import monopolies in the areas of agricultural and petroleum products are also in place. Due to the non-availability of representatives of local banks from either country in the other, LC opening is another major problem, since India allows opening of LCs only in the banks recognized by the Indian government**.** Other barriers include; visa & travel restrictions, hurdles in inter-

[22] Pandey, 2004 WP No. 140 ICRIER.

provincial movement of goods because of security checks and delays in clearing consignments, limited number of ports & inland custom ports for imports, etc.

In addition, India maintains tariff rate quotas in the agricultural sector, permitting the import of small quotas at moderate tariffs while applying much higher tariffs on imports in excess of the quota amounts. Besides, India uses technical barriers to trade in the form of technical standards and regulations, administered by the Bureau of Indian Standards, which operates a certification scheme for foreign exporters of products on a list of more than 100 items. To be sold in India, these products are required to be certified as meeting Indian quality standard mark. Moreover, India employs sanitary and phyto-sanitary rules in the agricultural sector, and other health and safety regulations (e.g. in pharmaceuticals), which may in part serve the purpose of discouraging trade. For instance, under health and safety concerns, India bans the import of used clothing and second hand household machinery and cars. India frequently uses the trade defense provisions to discourage imports. At present India has 133 antidumping and safeguards measures in force and reportedly about 30-35 investigations are under review/scrutiny.

Efficiency of customs operations can act as a de facto barrier to trade. As delays in clearing goods at customs effectively constitute an extra cost for traded products relative to domestically produced goods, long delays diminish the competitiveness of imports. Pakistan and India both have above average delays in customs clearance. According to the World Bank Investment Climate Surveys, the average number of days to clear imports through Pakistani customs was 17 days (2003), while it took an average of 10 days in India (2000). These compare with an average of 4 days for developed countries, and 6 days for East Asia.

In addition, some other restrictions have also hampered trade between India and Pakistan. A restrictive visa regime continues to curb travel between the two countries, thus limiting potential possibilities to engage in business contacts. Direct air travel between India and Pakistan used to be banned and was partially restored only in late 2003. Similarly, sea and land transportation between the countries is also difficult. Ships plying between Indian and Pakistani ports are obliged to first touch a third-country port before being allowed to harbor. In addition, India limits the ports and inland customs posts at which imports can be cleared for a number of products it labels as sensitive items. Moreover, the lack of coordination between the railway authorities of both countries and border closure continue to hamper land transportation. In the area of payments system, current restrictions and underdeveloped financial links act as an impediment to the efficient settlement of payments.

Some specific views of Multilateral Institutions and the business community in Pakistan about NTBs in India[23] are described below:

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[23] Mohammad Sulaiman & Dr. Muhammad Akbar, January 2005.

The World Bank: The tariffs and tax rates published by the Indian government are not transparent and there is no single official publication that includes all necessary information. Furthermore, different classification nomenclatures for customs tariffs and excise taxes and a somewhat different one for import trade, causes further confusion. In addition to tariff, India has the most complicated and pervasive non-tariff regime.

The International Monetary Fund: On the IMF trade restrictiveness index, India scores an 8 out of 10, compared to China’s score of 5 and 4 to 5 for other countries in East Asia. The efficiency costs associated with administrative hurdles and red tape have affected India’s investment climate. The non-tariff barriers together with known difficulties in the Indian market could make business in India difficult.

US Department of Commerce: Despite recent reforms, India retains one of the most restrictive trade regimes. The NTBs that remain include: import bans, import restrictions through state trading monopolies, and stringent standards or certification requirements.

The European Commission**:** The European Commission recently invited India for a settlement at the Dispute Settlement Board, alleging that India imposes non-tariff barriers to over 100 products included in a ‘sensitive commodities’ list.

Private Sector/Business Community**:** The response from the business community was that the main barriers to trade with India are political issues between the two countries. Other Pakistan-specific non-tariff barrier faced by Pakistani businessmen include: visa and travel restrictions in India; the non opening of land crossing, i.e. Wagha, Khokhrapar, and Qasur; inter-provincial movement of goods and differential sales tax regimes across Indian provinces; higher port congestion compared to Pakistan, higher port and demurrage charges, more paper work settlement, and more issues of trade and transport facilitation in India.

The Issue of MFN Status under the WTO

Given the improving relations between Pakistan and India in the recent past, an increased emphasis has been given to the issue of granting the Most Favored Nation (MFN) status to India. Pakistan and India are among the 25 founding members of the GATT. One of the fundamental principles of GATT is the MFN clause according to which any trade concession granted to one member of GATT must be extended to all members. Moreover, after the acceptance of the WTO Agreement, Pakistan has re-committed itself to the principles of GATT to pursue the objectives of free trade in a non-discriminatory multilateral framework. As a signatory to the Agreement, Pakistan is bound to grant MFN status to all member countries including India without any kind of discrimination.

MFN is one of the instruments in use by the WTO to make member countries' trade regimes competitive and non-discriminatory. Contrary to the popular view, MFN does not mean giving special treatment to imports from another country. MFN refers to non-discrimination among goods or services imported from other member countries and simply remove discriminatory practices in international trade. The principle requires that any favorable treatment given to one member of the WTO, such as lower tariffs or greater market access, has to be extended to import of similar products from all other member countries. For instance, following the grant of MFN status, US and China simply began to trade with each other on the same footing as with the rest of the world. The MFN principle, however, has some exceptions. For instance, signatories to a regional trade agreement can give concession to each other's exports over and above their obligations under the MFN principle.

India granted MFN status to Pakistan in 1996 but Pakistan has not yet reciprocated in the same manner. Since then India has been urging Pakistan to grant MFN treatment to India as well because such a status will ease qualitative and quantitative restrictions on the flow of goods between the two countries. Instead of granting MFN status, Pakistan has gradually increased the number of items permissible for trade with India and now maintains a 'positive list' of 768 goods which may be legally imported from India. It may be worth mentioning here that MFN status does not translate into trading 'freely' with India; it means trading with India in the same way as Pakistan trades with the rest of the world. The trading community in Pakistan seems to be in favor of granting the MFN status to India. The Karachi Chamber of Commerce and Industry (KCCI) has already recommended to the Government to grant MFN status to India because, in their view, it is unlikely that it will cause any damage to the Pakistani industry.[24] Pakistani manufacturers, however, feel that liberalizing trade between the two countries, after granting MFN status to India, will mostly benefit India given that it possesses a substantial industrial and engineering base. By conceding MFN status, Pakistan will suddenly expose its economy to the well diversified industrial structure of a large economy enjoying a substantial transport cost advantage over all its competitions. Moreover, dumping of cheap Indian products is also likely which will pose problems for the regulators in Pakistan. With the regional integration of South Asian countries along with binding MFN rules, it is expected that both countries will find it more beneficial to trade with each other.

Potential Areas for Mutual Trade between Pakistan and India

The current volume of trade between India and Pakistan is not commensurate with the existing potential. Although the recorded trade between India and Pakistan is merely $415 million (5-years average), but through third country and illegal channels, it is

[24] KCCI Report March 2004.

estimated between $250 million to $2 billion annually.[25] On the basis of FY04 trade, though the overall market size available for Pakistan's exports may reach $ 5.1 billion, given the fact that additional exportable surplus might not be available in the short run, the potential exports to India is estimated around $2.5 billion . On the other hand, the size of potential imports from India is about US $2.7 billion. The total trade potential (exports plus imports), between Pakistan and India, therefore, could be around $5.2 billion. This can be compared with other estimates of $1.85 billion[26] in a World Bank study, using fixed effects gravity model of bilateral trade based on 2001 data and $6.5 billion[27] in the ICRIER study (December 2004), using the augmented gravity model specification. Among all SAARC members India's trade potential is indicated only for Pakistan in the ICRIER study. Baroncelli (2006) also derives a trade potential, including unofficial trade of $3.2 billion, and Batra gravity model (2004) estimated $6.6 billion. The Federation of Indian Chambers of Commerce and Industry (2003) estimate potential of trade around $6 billion to $8 billion. The potential of trade between the two countries quoted by the KCCI lies within the vicinity of $5 to 10 billion,[28] which can be fully explored and expanded by adopting mutually beneficial policies and joint strategies. Indian and Pakistani business leaders, during their meetings at different times, have identified various areas which have a substantial potential for cooperation and an immense scope for bilateral trade. These include tea, spices, auto parts, consumer and light engineering goods, tires and transport equipment, entertainment, healthcare, IT and pharmaceuticals from India, and fresh and dry fruits, sugar, raw cotton, gems, fish, marbles and onyx, power and textiles from Pakistan. The literature review reveals considerable potential for expanding bilateral trade. Revealed Comparative Indices (RCI) show that India being a larger economy has comparative advantage in significantly more tradable items compared to Pakistan. These include: food and beverages, chemicals, machine tools, household electronics, steel products and transport equipment such as motor vehicles, motor cycles and bicycles. Pakistan has comparative advantage over India in a range of products, including cotton textiles, rice, leather and leather products, and surgical goods.[29] Intra-industry trade indices also show that there is intra-industry trade in basic manufactures, machinery and transport equipment and miscellaneous manufactured articles. Potential sectors for bilateral trade between India and Pakistan are discussed below.

Potential Sectors for Trade

The potential for trade between Pakistan and India can be assessed keeping in view the trade volume which currently flows through informal channels or via third countries.

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[25] See footnote 6 and 7.
[26] See footnote 2.
[27] Batra, 2004.
[28] See footnotes 17 and 24; No details regarding the basis of the estimates are mentioned in the report.
[29] Taneja in Naqvi and Schuler, 2006.

This provides us with a rough estimate of the trade volume which may change its route, i.e. from informal to formal or from third country to direct trade, as a result of removing trade barriers. It would, however, be difficult to assess how much new trade activity is likely to be generated by the liberalization of the trade regime and how backward or forward linkages are likely to impact other production/services activities. The assessment of the potential impact has several facets and is beyond the scope of this study; however one element can be unearthed by analyzing the existing formal trade patterns of the two countries. By comparing Pakistan's exports to the rest of the world with India's imports from the rest of the world, potential sectors can be identified where the scope of the existing exportable items could be expanded. Similarly, potential items which could be imported from India can be judged by comparing India's exports and Pakistan's imports. The following section contains the analysis of exports and imports of Pakistan and India at the 8-digit level HS classification[30] for the two fiscal years FY03 and FY04 by comparing the unit values (presuming it reflects the price content) to identify the potential sectors/items. Since the data covers the full year trade, the difference in time periods of the fiscal years of Pakistan and India has been ignored. Further, the fact that the existing trade between the two countries is nominal given their overall trade with the rest of the world has also been ignored in the analysis of the data. The results are discussed in the following sections.

Potential Items for Export to India

A comparison of Pakistan's exports with Indian imports from the rest of the world indicates various potential sectors which can be explored in case trade between the two countries is liberalized. Of the total value of Pakistan's exports in FY04, 32 percent represents those items which are also imported by India from the rest of the world, constituting one-third of the total Indian imports. There are about 1181 '8-digit-level' items worth $3.9 billion common between Pakistan's exports and India's imports during FY04, covering 45 percent of the total number of items exported by Pakistan (**Table 5).** These pertain to major sectors like textiles and textile articles, prepared foodstuffs, spirits and vinegar etc., raw hide and skins, leather, fur skins, etc., mineral products, plastics, rubber, vegetable products, machinery, mechanical appliances and electrical equipment, etc **(Annexure 3).** Majority of the items (about 60 percent) have exports worth less than or equal to $0.1 million and the textiles and textile articles remains the dominant sector (around 68 percent of the export value of common items). Nevertheless, sectors other than the textiles constitute 80 percent of the total number of common items and cover items for which there is a wide scope for exports**.**

The Indian imports under these non-textile items constitute over 98 percent of the total value of imports in common items and 45 percent of these items have individual imports worth more than or equal to $5 million. The bulk of these common items

[30] Harmonized System of Commodity Classification: World Customs Organization.

imported by India pertain to mineral oil and products (mineral fuel/oil/wax, and bituminous) and since Pakistan itself is a major importer of petroleum products, this sector probably does not offer much scope for increasing exports to India. The remaining sectors, however, still account for a significant proportion as Indian imports in these categories amounts to $5.8 billion. The major sectors other than mineral oil and products include: machinery, mechanical appliances and electrical equipment, etc.; vehicles, aircrafts and parts, etc.; vegetable products; products of chemical or allied industries (including items like fertilizer); plastics and rubber and textiles and textile articles.

Table 5: Frequency Distribution of Common Items between Pak Exports and Indian Imports

(US$ million)

Export/Import Volume	FY03				FY04			
	Pakistan		India		Pakistan		India	
	No. of items	Exports	No. of items	Imports	No. of items	Exports	No. of items	Imports
Less than or equal to								
0.1	511	12	185	7	704	17	272	10
0.2	69	10	85	12	106	15	104	15
0.3	37	9	56	14	57	14	50	12
0.4	17	6	37	13	31	11	49	17
0.5	17	8	30	13	23	10	43	20
1	40	29	77	56	67	48	132	94
5	63	146	195	481	98	219	288	722
Above 5 million	42	1549	131	19272	95	3575	243	25402
Common Items	**796**	**1768**	**796**	**19868**	**1181**	**3909**	**1181**	**26291**
Total No. of Items: Exports / Imports	**2391**	**11978**	**7900**	**61412**	**2646**	**12313**	**8887**	**78150**

In order to analyze the potential sectors on the basis of pricing, the average unit price of the Pakistani exports and Indian imports as an approximation of the actual prices are used. Since these values also reflect the quality of the products, as such two items with the same HS-code may still not be comparable because their unit values may be different due to the difference in quality. An analysis of the unit values of Pakistan exports and Indian imports reveals that 70.3 percent of the common items exported from Pakistan have unit values less or equal to the Indian imports unit values (**Table 6).** This share remains 68 percent in case of only those items which have export value of more than one million dollars – though the number of items declines drastically to just 104. Although the differential between the unit values might be due to the quality factor, still this shows that there is a large scope for the export of these items simply by producing the quality required in India.

As mentioned earlier, the overall market size for items with unit values less than that of India is around $5.1 billion. The actual potential to export, however, depends upon the availability of exportable surplus. In the short run, it is expected that trade might divert from other destinations to India for two reasons. First, due to lower transportation costs, the profit margins may give an incentive to exporters to change the destination; second, traders may start exporting to make inroads in the Indian markets to diversify their markets and to take advantage of a socially identical consumer base. Part of the increased trade may comprise of diversion from the existing informal trade. The maximum diversion of exports to India is estimated at US $2.5 billion, which represents FY04 exports of 692 common items to destinations in the rest of the world, having unit values less than that of Indian imports. Nevertheless, the likelihood of such diversion is very low.

Table 6: Frequency Distribution of Ratio Between Unit Values of Pak Exports and Indian Imports

		All common items		**> US$ 1 million**	
Ratio of unit values (Pak/India)		**FY03**	**FY04**	**FY03**	**FY04**
Less than or equal to	0.2	140	204	13	20
	0.4	146	179	24	27
	0.6	91	142	6	30
	0.8	63	87	9	11
	1	48	80	9	16
	1.2	45	59	5	12
	1.4	26	37	6	4
	1.6	15	35	2	8
	1.8	16	28	0	3
	2	11	15	3	2
Above 2		67	118	6	20
Common Items with UV		668	984	83	153
Total No. of Common Items		**796**	**1181**	**796**	**1181**

Of the common items with unit values of Pakistan's exports less than twice the unit value of Indian imports (representing individual import value of over $100 million), the major categories include nuclear reactor, boiler, machinery and parts; aircrafts, spacecrafts and parts; vehicles other than rail or tramway parts; plastics and articles thereof; optical, photographic, cinematographic items; fertilizers; wool, fine or coarse animal hair; miscellaneous chemical products; rubber and articles thereof; man-made filaments; ships, boats and floating structures; edible fruits and nuts, fresh/dry and edible vegetables roots tubers *(***Annexure 4).** Within these categories, however, the trend of import of some of the items (such as *fertilizers, man-made filaments* and *edible vegetables roots tubers*) in India is quite volatile and probably depends on the domestic supply situation. Currently, Pakistan's exports in these categories are also quite low.

Potential Items for Imports from India

Over the last few years, Pakistan's overall imports have largely been concentrated in the machinery, chemicals and petroleum groups due mainly to growing needs of the economy. Imports of textile machinery have in particular witnessed a substantial growth due to the BMR activities of the textile sector in order to cope with the challenges of a quota free regime. Imports in other groups also reflect the growth in the size of the economy. While making assessment of the needs for Pakistan's imports by comparing items imported by Pakistan with those which are exported by India, it is observed that Indian exports still covered almost 53 percent of Pakistan's total import items**.**

In FY04, there were 2,646 common items of Pakistan's imports worth over $7 billion (which accounts for 53 percent of the total import items and 47 percent of the aggregate value of imports). Under these items India also had exports worth over $15 billion (covering 24 percent of the total value of imports). Analysis reveals that 41 percent of the total common items have individual imports of less than or equal to $ 0.1 million only. Moreover, imports are concentrated to few items, i.e. 6.4 percent of the total common items with individual imports above $5 million contribute 83 percent of import value of these common items **(Table 7).** Excluding mineral products, the bulk of Pakistan's imports pertains to products, i.e. chemical or allied industries; machinery and mechanical appliances; electrical equipment, etc.; vehicles, aircrafts, etc.; vegetable products; base metals and its articles; plastics, rubber natural pearls, precious or semi precious, etc.; textiles and textiles articles; animal or vegetable fats and oils, etc.; pulp of wood, waste and scrap, etc. and optical, photographic and surgical instruments, etc.

Table 7: Frequency Distribution of Items Common in Pak Imports and Indian Exports

(In million US$)

Export/Import Volume	**FY03**				**FY04**			
	Pakistan		**India**		**Pakistan**		**India**	
	No. of items	**Imports**	**No. of items**	**Exports**	**No. of items**	**Imports**	**No. of items**	**Exports**
Less than or equal to								
0.1	885	26	468	20	1094	34	475	20
0.2	241	35	226	32	312	45	270	38
0.3	132	32	126	31	196	48	156	38
0.4	89	31	129	44	128	44	135	46
0.5	53	23	79	35	97	44	119	53
1	168	118	248	175	266	194	398	280
5	224	476	386	867	383	829	673	1599
Above 5 million	112	3312	242	5949	170	6061	420	13176
Common Items	**1904**	**4054**	**1904**	**7152**	**2646**	**7298**	**2646**	**15249**
Total No. of Items: Exports/ Imports	**4754**	**12220**	**9554**	**52719**	**4948**	**15592**	**10224**	**63842**

Within these categories, India's exports are to the tune of $12.8 billion but excluding *textiles and textiles articles* (for which Pakistan is a major exporter) this comes to $8.5 billion (**Annexure 5 Part I).** While comparing the unit values of Pakistan's imports and Indian exports, it is observed that for 48.7 percent of the items, the unit values for Pakistan's imports are more than the unit values of India's exports **(Table 8)** and import value of these potential items amounted to US $2.7 billion in FY04.

These items pertain largely to sectors like nuclear reactor, boiler, machinery & parts; organic chemicals; electrical machinery & parts; optical, photographic**,** cinematographic and surgical instruments; inorganic chemicals compounds; plastics and articles thereof; articles of paper pulp/paper-board; articles of iron or steel; miscellaneous chemical products; rubber and articles thereof; copper and articles thereof ***(*Annexure 6*).*** Similarly 51.3 percent of items with individual imports of over $1 million have unit values greater than that of Indian exports unit values.

It is pertinent to note that after excluding the items which are currently permissible for imports from India; about 45 percent of the items still remains in the common list which could be imported from India at a lesser cost than the current cost of import from the rest of the world. Based on the average unit values of Indian exports in the FY03 and FY04, it is estimated that allowing import of such items from India (i.e. expanding the current list of positive items) the average saving for Pakistan could range between $400 million to $900 million.

Table 8: Frequency Distribution of Ratio Between Unit Values of Pak Imports and Indian Exports

Ratio of unit values (Pak/India)		Common Items				Common Items which are not allowed to Import from India			
		All		> US$ 1 million		All		> US$ 1 million	
		FY03	FY04	FY03	FY04	FY03	FY04	FY03	FY04
Less than or equal to	0.2	152	210	8	31	138	194	7	29
	0.4	203	254	38	44	181	236	30	40
	0.6	186	263	33	55	163	242	27	47
	0.8	167	257	42	51	147	236	36	46
	1.0	161	231	45	68	145	208	40	59
	1.2	131	180	36	56	111	157	30	46
	1.4	97	134	15	31	81	116	12	27
	1.6	72	112	14	22	62	107	10	21
	1.8	56	92	10	22	51	84	10	21
	2.0	59	67	7	13	54	62	7	13
Above 2		372	568	59	118	347	539	54	114
Common Items with UV		**1656**	**2368**	**307**	**511**	**1480**	**2181**	**263**	**463**
Total No. of Common Items		**1904**	**2646**	**1904**	**2646**				