SOUTH ASIA DEVELOPMENT FORUM

OVERVIEW

A Glass Half Full

The Promise of Regional Trade in South Asia

Sanjay Kathuria, Editor

WORLD BANK GROUP

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Overview

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This booklet contains the overview, as well as a list of contents, from *A Glass Half Full: The Promise of Regional Trade in South Asia*, doi:10.1596/978-1-4648-1294-1. A PDF of the final, full-length book will be available at https://openknowledge.worldbank.org/, and print copies can be ordered at http://Amazon.com. Please use the final version of the book for citation, reproduction, and adaptation purposes.

South Asia Development Forum

Home to a fifth of mankind, and to almost half of the people living in poverty, South Asia is also a region of marked contrasts: from conflict-affected areas to vibrant democracies, from demographic bulges to aging societies, from energy crises to global companies. This series explores the challenges faced by a region whose fate is critical to the success of global development in the early 21st century, and that can also make a difference for global peace. The volumes in it organize in an accessible way findings from recent research and lessons of experience, across a range of development topics. The series is intended to present new ideas and to stimulate debate among practitioners, researchers, and all those interested in public policies. In doing so, it exposes the options faced by decision makers in the region and highlights the enormous potential of this fast-changing part of the world.

Contents

Foreword

I am delighted to have in my hand a book that asks how we can turn proximity from a burden to an advantage. *A Glass Half Full: The Promise of Regional Trade in South Asia* advocates an approach of open regionalism, using intraregional trade as complementary to, and as a stepping stone for, deeper global integration. This book, written by Sanjay Kathuria and a team of South Asian researchers, stands out for its effort to bring together in a single tome theoretical knowledge and ground realities of trade in South Asia.

This is a much-needed book. I have long been acutely aware of the huge potential of regional trade and exchange in South Asia, which can power the entire region to grow faster and improve standards of living. To leave this untapped is a wastefulness that has little justification in a region that still has so much poverty and malnutrition. It is sobering to recall that South Asia still accounts for 33 percent of the world's poor and 40 percent of the world's stunted children. I have for long argued that the right way to evaluate a society is in terms of the well-being of its bottom segment.

The immense value of this book lies in the fact that it does not just make a case for greater regional trade and cooperation; rather, it shores it up with detailed data and surveys conducted specially for this project. All policy makers of the region would be well-served to read this book, which shows that had South Asia not created artificial barriers, our countries would be trading three times as much among themselves as they currently do.

Recent growth in most major South Asian economies has been the subject of global interest and analysis. Take the case of Bangladesh. Once a basket case, Bangladesh has become one of Asia's unexpected success stories in recent years, in terms of growth and also in terms of many social indicators. But there is no room for complacency. This is where Bangladesh can harness the fruits of deeper cooperation between itself and its neighbors on trade, investment, connectivity, and energy—efforts that will be critical for sustainability and overall development.

This is true for all South Asian countries, large or small. Even India, the largest country in the region, will benefit. Deeper regional trade and connectivity can, for example, reduce the isolation of northeast India, give India better access to markets in East Asia, and allow it to substitute fossil fuels by cleaner hydropower from Nepal and Bhutan. Trade between India and Pakistan is a paltry US$2 billion. The book shows that without artificial barriers, this should be US$37 billion. My hope is that such interaction will go beyond economic gains and help promote trust and peace, as the book illustrates so well.

One learns an immense amount from this monograph, such as the role of haats on the edge of India and Bangladesh. These local border markets enable small volume trading for local communities on both sides of the border. An initiative by the governments of Bangladesh and India aimed at recapturing the once thriving economic and cultural relationships is now changing cross-border relations, reducing incentives for smuggling. Moreover, the interaction across the border has bolstered trust and cooperation among Indians and Bangladeshis.

Another interesting case is India-Sri Lanka air services liberalization. Today, Indians and Sri Lankans enjoy direct connections from Colombo to 14 Indian cities, with a total of about 147 flights per week, resulting in India becoming the largest source of foreign tourists in Sri Lanka. Overall, however, connectivity among South Asian countries, even for capital cities, is still very limited. This deters trade.

Despite the existence of the South Asian Free Trade Area (SAFTA) since 2006, we are far from achieving the goal of tariff-free trade. This report brings to light fresh evidence on rather opaque "paratariffs" levied by some countries in the region. Such tariffs are basically import duties in disguise, and imply that, in practice, there are very substantial duties on a wide range of products traded within South Asia, despite SAFTA.

When I joined the World Bank, one of my first projects was to initiate a report on mind, society, and behavior—about the role of psychology and social norms in promoting development. When we think of development and growth, we focus on getting our fiscal policy right, monetary policy right, and taxation system right, and indeed these are extremely important. But a society's development also depends on the social norms and mindsets of the people. Cross-country studies show that nations in which there is a lot of trust among people do well economically. One message that emerges from this multicountry study strongly reinforces this. Trust promotes trade; and trade fosters trust, interdependency, and constituencies for peace. Bad history can still result in positive outcomes, provided our countries take incremental yet concrete steps to tap the potential of deeper integration in the region.

As economists, our primary function is to encourage an informed debate, so that policy makers have solid foundations on which to build their actions. This report more than fulfills its share of the bargain. There is a lot for the important stakeholders, especially policy makers and civil society, to now take forward.

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About the Editor

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Overview

SANJAY KATHURIA AND PRIYA MATHUR

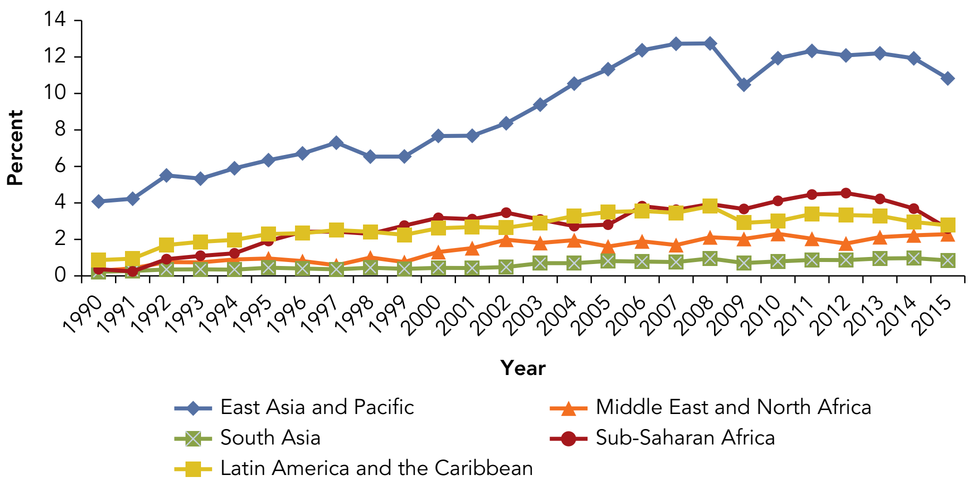
The Issue

Trade has played a critical role in global poverty reduction. In harnessing the potential of trade, some of the most successful countries, such as economies in East Asia, Europe, and North America, have developed strong trade relationships with their neighbors. Intraregional trade accounts for 50 percent of total trade in East Asia and the Pacific and 22 percent in Sub-Saharan Africa, while it accounts for a little more than 5 percent of South Asia's total trade. Even in the case of the United States, a large continental economic power, its two largest trading partners are its immediate neighbors, Canada and Mexico. Using economic size as the denominator does not alter the result. Intraregional trade as a share of regional gross domestic product (GDP) hovers around only 1 percent in South Asia, versus 2.6 percent in Sub-Saharan Africa and about 11 percent in East Asia and the Pacific, reflecting low levels of trade within the South Asian region relative to the size of the economies (figure O.1).

In South Asia, both nature and man have contrived to fragment the region, denying countries and people the benefits of proximity. Gravity models show that total goods trade within South Asia could be worth $67 billion rather than the actual trade of only $23 billion. Formal trade between India and Pakistan could, for instance, be 15-fold more than current levels.

Despite these handicaps, trade among countries in South Asia continues to grow. Where the barriers are high, trade often flows along informal routes, through third

FIGURE O.1 Intraregional Trade as a Share of Regional GDP



Sources: Data from UN Comtrade (United Nations Commodity Trade Statistics Database), Statistics Division, Department of Economic and Social Affairs, United Nations, New York, http://comtrade.un.org/db/; WITS (World Integrated Trade Solution) (database), World Bank, Washington, DC, http://wits.worldbank.org/WITS/.

countries or by avoiding customs checks. All countries in the region, irrespective of size, location, and endowments, gain from regional trade, although the impact is not symmetric. Consumers gain from access to a variety of food products, services, and consumer goods at lower prices. Producers and exporters gain from greater access to inputs, investment, and production networks. Firms, too, gain from regional trade through expanding market access in goods and services. Access to regional markets has also been important for services such as electricity and tourism. Gains from deeper cooperation are pronounced among landlocked countries and relatively isolated subregions.

And, yet, so much more is possible. India and Pakistan have merely scratched the surface of their bilateral trade potential. Only a fraction of the hydropower potential of the region has been tapped. Landlocked Afghanistan, Bhutan, and Nepal, as well as Northeast India and Khyber-Pakhtunkhwa and the Federally Administered Tribal Areas in Pakistan, could gain much more from better transit and connectivity. Regional tourism could grow much more quickly, as could trade in other services such as education, health care, and financial services. More foreign direct investment (FDI) within the region could help spawn regional and global value chains.

The report unpacks four of the critical barriers to effective integration and to resolving the unmet potential in trade in South Asia, as follows:

- Nontransparent and protective tariffs, especially paratariffs, which are taxes levied on imports, but not on domestic output. These paratariffs, along with the widespread exclusions from tariff preferences in the form of sensitive lists, have rendered the region's free trade agreement ineffective. They are analyzed in detail in the case of three countries that make extensive use of paratariffs.

- Real and perceived nontariff barriers, which exacerbate the trust deficit and affect the growth of trade. These are examined through the lens of specific products and trading relationships.
- Higher costs of connectivity, arising, for example, from restrictive bilateral air travel agreements. These are investigated using the India–Sri Lanka air travel agreement as a case study.
- The broader trust deficit, which has affected the overall South Asia integration effort. The analysis draws lessons from the Bangladesh–India border haats—local markets enabling small-volume trading among communities—that involve close people-to-people contacts and have helped reduce the trust deficit.

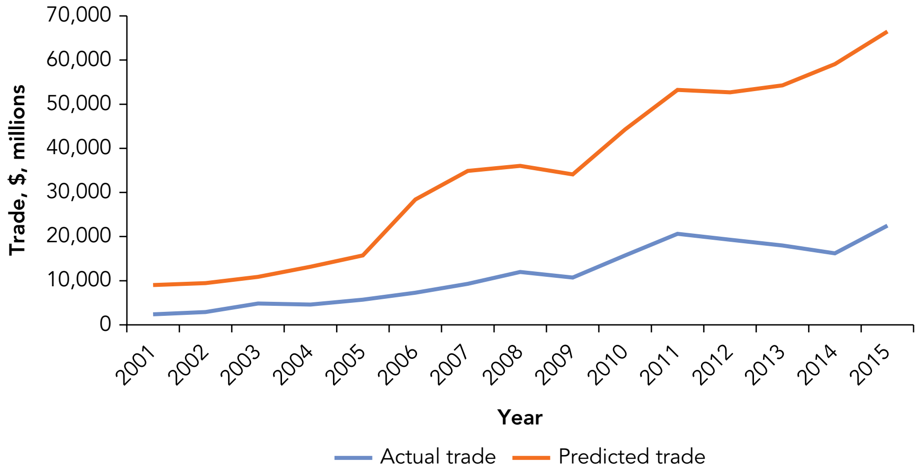
The report is not intended to be a complete treatment of country-specific trade issues, nor does it suggest that there be an exclusive focus on regional trade. The authors recognize that regional trade provides one among many development opportunities. First, intraregional trade is a subset of global trade, and global trading opportunities supply the greatest welfare gains. For example, most countries would benefit from greater trade with China; on the western side of the region, Afghanistan and Pakistan would benefit from expanded trade with the Islamic Republic of Iran and Turkey. Second, for a few small or landlocked countries in the region, a case may be made for diversification of trade sources within South Asia as well as beyond the region. The report focuses on the lost trading opportunities at the doorstep of South Asian countries—opportunities that, it shows, are significant and merit detailed examination. Moreover, the pursuit of intraregional trade need not occur at the expense of other trading opportunities; indeed, an open regionalism approach can help countries use regional integration as a stepping-stone to global integration. Finally, there are other regional cooperation possibilities in energy, transport connectivity, and water and ecological integrity, which are part of a broader World Bank Group program to support regional integration in South Asia.

The Symptoms

Actual intraregional trade in South Asia has not only been consistently below potential; the gap, based on the gravity model, has been widening, from only $7 billion in 2001 to $44 billion in 2015, partly because of the significant acceleration in GDP growth in South Asia relative to the world over that period (figure O.2).

Variations occur across countries in the gap between current and potential trade: India's trade with Pakistan, Bangladesh, and Afghanistan shows the highest levels of

FIGURE O.2 Intraregional Trade Potential in South Asia



Source: Calculations based on data from CEPII Gravity Database, Centre d'Etudes Prospectives et d'Informations Internationales, Paris, http://www.cepii.fr/cepii/en/bdd_modele/presentation.asp?id=8; WITS (World Integrated Trade Solution) (database), World Bank, Washington, DC, http://wits.worldbank.org/WITS/.

undertrading (to the tune of $35 billion, $10 billion, and $700 million, respectively). In contrast, the trade between Afghanistan and Pakistan, India and Sri Lanka, and India and Nepal shows overtrading (of more than $1 billion in each case). However, further disaggregation between exports and imports reveals that Sri Lanka and Nepal underexport to India, even as they import more than predicted by the gravity model.

The force of gravity—the degree of trade attraction between countries—is also manifest in high levels of informal trade. Informal trade has been estimated at 50 percent of formal trade in South Asia, aggregating assessments of various studies for years between 1993 and 2005. India's informal trade with Nepal was as large as the formal trade; with Pakistan, it was 91 percent of formal trade; with Sri Lanka, it was about 30 percent; and, with Bhutan, it was almost three times the formal trade. More recent bilateral estimates of trade between India and Pakistan indicate that informal trade between the two countries in 2012–13 was almost double the value of formal trade, and most of this was routed through a third country.

The Barriers

The large gaps between actual and potential trade arise because countries in the region have erected barriers against each other. These barriers include high tariffs and paratariffs, despite a regional free trade agreement that came into force in 2006; disproportionately high costs of trading within the region that derive from poor transportation and logistics infrastructure and inefficient trade facilitation; complicated and nontransparent nontariff measures (NTMs), that is, policy measures other than tariffs that affect the free flow of goods and services across borders in the region; additional barriers to trade between the two largest economies in the region, India and Pakistan; constraints on trade in services, particularly in trade and visa regimes; and below-potential FDI, which also affects the deepening of regional value chains. Some of these barriers are highlighted below.

South Asian trade regimes discriminate against neighbors. In South Asia, protection is greater in the case of imports from within the South Asia region than from the rest of the world, as reflected in the overall trade restrictiveness index. This index measures the uniform tariff equivalent of a country's tariff and nontariff barriers that would generate the same level of import value for the country in a given year. As indicated in table O.1, the indexes are two to nine times higher for imports from the South Asia region than for imports from the rest of the world in all countries except Afghanistan. In the two largest economies in the region, India and Pakistan, the indexes are nine and six times higher, respectively, for imports from the South Asia region than for imports from the rest of the world. Moreover, although the average NTM burden may not appear high, it is high for specific product and market combinations in South Asia. It varies from over 75 percent to over 2000 percent; Sri Lanka's trade regime leads to that country's consistent appearance on the list of highest import ad valorem equivalents in the region.

Tariffs reappear in other forms. Even as South Asian countries have reduced tariffs, several countries in the region have simultaneously introduced protectionist paratariffs. Besides undermining tariff liberalization, these nontransparent paratariffs are not part of the phaseout program under the South Asian Free Trade Area (SAFTA) or other free trade agreements in the region, which reduces the preference margins for SAFTA partners. Bangladesh, Pakistan, and Sri Lanka maintain high paratariffs.

TABLE O.1 Overall Trade Restrictiveness Indexes, Selected Countries, South Asia, 2011

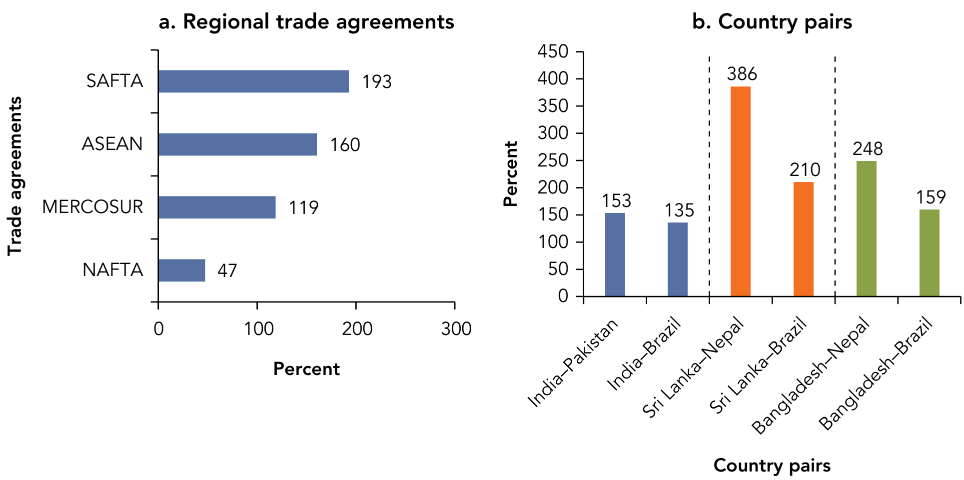
	Origin of imports	
Importing country	**South Asia**	**Rest of world**
Afghanistan	3.84	4.65
India	4.59	0.50
Sri Lanka	1.01	0.33
Nepal	10.59	6.87
Pakistan	3.00	0.51

Source: Chapter 1, box 1.2.
Note: The overall trade restrictiveness indexes are computed using applied tariffs that take into account bilateral preferences.

Shackled connectivity is reflected in the disproportionately high costs of trade. The costs of trading, which are a reflection of the transportation and logistics infrastructure and the efficiency of customs and border procedures, are considerably higher within South Asia than within other trade blocks of comparable size (figure O.3). For instance, the average level of trade costs is 20 percent higher between country pairs in South Asia than between country pairs in East Asia. It currently costs more to trade between some countries in South Asia than between these countries and, say, Brazil (shown for selected pairs in figure O.3).

Nontariff barriers erode market access. Complicated and nontransparent NTMs erode the market access granted by South Asian countries to each other and are sometimes held responsible for undermining the unrestricted market access granted to least developed countries by India. While all countries can legitimately impose NTMs to safeguard the interests of consumers and protect plant and animal life, NTMs become nontariff barriers if they are more burdensome than necessary to achieve a legitimate goal, for example, if border testing of imports takes inordinate amounts of time. An example of a nontariff barrier is the port restrictions imposed by several countries in the region. For instance, Pakistan allows only 138 items to be imported from India over the Attari–Wagah land route, the only land port between the two countries, despite the

FIGURE O.3 Average Intraregional and Interregional Trade Costs, 2010–15



Source: Calculations based on data from the ESCAP–World Bank Trade Cost Database, United Nations Economic and Social Commission for Asia and the Pacific, Bangkok; World Bank, Washington, DC, http://www.unescap.org/resources/escap-world-bank-trade-cost-database.

Note: The unit of measurement is the ad valorem equivalent trade costs in percent. For the detailed methodology, see the source. The average intraregional trade costs are simple averages of the trade costs between country pairs in the respective trade blocs and across years; the average bilateral trade costs used in intraregional versus interregional comparisons are simple averages across years. ASEAN = Association of Southeast Asian Nations; MERCOSUR = Argentina, Brazil, Paraguay, Uruguay, and República Bolivariana de Venezuela; NAFTA = North American Free Trade Agreement; SAFTA = South Asian Free Trade Area.

long, shared land border. This means that bilateral trade is dominated by trade along the sea route, which is not necessarily the most cost-effective for two countries with a long shared land border. Bangladesh and India also impose some restrictions on imports from each other at certain ports.

Toward Realizing South Asia's Trade Potential

Given the context and situation in South Asia, incremental yet concrete steps to tap the potential of deeper integration are needed. This policy-focused report is advanced in this spirit, outlining specific actions to achieve concrete, measurable progress in different areas. It addresses four specific barriers that have constrained trade within South Asia: tariff and paratariff barriers; nontariff barriers, examined through the lens of selected products in Bangladesh–India and India–Nepal trade; the high costs of connectivity, focusing on air services and investigated using the India–Sri Lanka air travel agreement as a case study; and the trust deficit among South Asian countries, which underscores the importance of people-to-people interactions through initiatives such as the Bangladesh–India border haats program.

TARIFF AND PARATARIFF BARRIERS

Despite significant liberalization in tariff regimes by South Asian countries since the 1980s, average tariffs are still high. In 2016, average tariffs in South Asia were 13.6 percent, more than double the world average (6.3 percent) and the highest among major regions of the world. This high level of protection masks wide cross-sector variations in tariffs within many countries in South Asia, substantial protection on consumer goods, and a large wedge in protection between consumer goods and intermediate goods.

The study highlights two critical reasons that stand out in explaining the deficit in SAFTA's performance. First, each country maintains a long sensitive list of products that are exempted from the tariff liberalization program. Second, several countries in the region maintain high paratariffs, which have not been included in the tariff preference programs in free trade agreements.

Under SAFTA, the goal of duty-free trade is compromised by long sensitive lists that are maintained by all countries. Almost 35 percent of the value of intraregional trade in South Asia is subject to sensitive list tariffs; about 44 percent–45 percent of the imports from other SAFTA members fall under sensitive lists in Bangladesh and Sri Lanka; over 39 percent of India's exports to the region fall under the sensitive lists of various partners. SAFTA does not provide a clear guideline for phasing out the sensitive lists.

Maintained by several countries in the region, paratariffs are not part of the phaseout program under SAFTA or other free trade agreements in the region. By reducing the preference margins for SAFTA partners, paratariffs undermine the goals of SAFTA. Among the major economies in South Asia, Bangladesh, Pakistan, and Sri Lanka maintain high

TABLE O.2 Prevalence of Paratariffs in Bangladesh, Pakistan, and Sri Lanka

Country, tariff	Tariff lines affected: Number	Tariff lines affected: Share, %	Rates, percent of affected tariff lines
Bangladesh			
Regulatory duty	3,030	45.0	3 (99%), 15, 20
Supplementary duty	1,523	22.6	20 (61%), 45 (21%), 30 (5%), 10 (4%), 60 (4%), and six other rates between 100% and 500% (5%)
Value added tax	730	10.8	15 (100%)
Pakistan			
Regulatory duty	1,314	18.5	5 (30%), 10 (30%), 15 (26%), 30 (4%), and nine other rates between 2% and 60% (9.6%)
Additional duty, autos	146	2.1	15, 25, 30, 35
Additional duty, general	7,032	99.3	1 (100%)
Sri Lanka			
Ports and airports development levy	5,827	83.7	7.5 (89%), 2.5 (11%)
Cess	1,937	27.8	Ad valorem: 598 (1%–70%); specific: 522 (SL Rs 4/kg to SL Rs 6,000/kg); mixed: 817 (8% or SL Rs 25/kg to 35% or SL Rs 2,000/kg)

Source: In cooperation with the Policy Research Institute of Bangladesh, calculations based on data from the National Board of Revenue (Bangladesh), Sri Lanka Customs, and the Federal Bureau of Revenue (Pakistan).
Note: Total number of tariff lines: Bangladesh = 6,739 (fiscal year 2016/17); Pakistan = 7,086 (fiscal year 2016/17); Sri Lanka = 6,965 (2016); kg = kilogram.

paratariffs (table O.2). They are not used in Nepal and are small in India. No data on paratariffs are available for Afghanistan, Bhutan, or Maldives.

Paratariffs can significantly increase the nominal protection rate. With the inclusion of paratariffs, the simple average tariff in Bangladesh in fiscal year 2016/17 almost doubles, from 13.3 percent to 25.6 percent; in Sri Lanka in 2016, the average tariff more than doubles, from 10.8 percent to 22.4 percent. For many individual products in these countries, the combination of paratariffs and customs duties results in high protection rates on the order of 40–80 percent.

The lack of effectiveness of SAFTA has created incentives for countries to pursue other free trade agreements both within and outside the region. For example, India has comprehensive economic partnerships, economic cooperation agreements, or free trade agreements with some 18 countries or country groups and is pursuing many others. Pakistan has 10 agreements in force, and more are being negotiated. Other countries, including Sri Lanka and Bangladesh, are also pursuing free trade agreements with multiple partners. Some of these other agreements could have led to the erosion of effective preferences within SAFTA and, in certain cases, may even have diverted some trade away from South Asian countries. Given that South Asian trade regimes discriminate against each other, an appropriate response is to eliminate such discrimination and make SAFTA (and other bilateral arrangements in South Asia) as effective as possible.

The report suggests three major areas of reform to make tariff liberalization under SAFTA more meaningful. They are also relevant to bilateral or subregional free trade agreements. These suggestions should be seen within the context of open regionalism, whereby regional trade integration is complementary to global integration.

First, to increase the volume of regional trade in South Asia and allow a genuine SAFTA to emerge, countries in the region should agree on an accelerated, time-bound schedule for the elimination of sensitive lists within a period not exceeding 10 years, except for a few products of exceptional concern. A first step could be to lower the number of products in SAFTA sensitive lists to align them with sensitive lists in bilateral South Asian agreements, such as the India–Sri Lanka and Pakistan–Sri Lanka free trade agreements.

Second, paratariffs need to be squarely addressed, with a panel of experts establishing a schedule for paratariff elimination within a time period that is credible, sufficiently ambitious, and acceptable to all parties. This will level the playing field between the countries that impose paratariffs and those that do not and enable tariff preferences to become more effective within SAFTA. An obvious starting point would be the reduction and accelerated elimination of paratariffs on items not on sensitive lists.

Third, SAFTA members should continue their efforts to eliminate tariffs on intraregional trade associated with their nonsensitive lists. Although the initial plan was to achieve full trade liberalization in SAFTA by 2016 (for nonsensitive items), some tariffs are still charged on imports from member countries. The goal should be to reduce all tariffs, inclusive of paratariffs, to zero for all products on nonsensitive lists (instead of the 0-to-5 percent range as originally planned). If the sensitive lists are reduced over 10 years, as suggested above, the zero-tariff formula for nonsensitive items would mean that protection would only occur (at least for SAFTA trade) through the sensitive list approach.

NONTARIFF BARRIERS

Traders across South Asia often complain about nontariff barriers. However, many complaints arise from lack of information on regulations and standards and inadequate infrastructure for measuring and certifying quality, rather than protection by the importing country.

It is necessary to address burdensome NTMs in South Asia by distinguishing between real and perceived complaints, thereby focusing the attention of policy makers on genuine issues; dealing with the misperceptions of traders; and, ultimately, bridging the gap between perceptions and objective evidence. This report examines NTMs in bilateral trade between Bangladesh and India and between India and Nepal in selected products of significance (exports of tea, cardamom, and medicinal and aromatic plants from Nepal to India; exports of processed foods, ready-made garments, and jute bags from Bangladesh to India; exports of pharmaceutical raw materials to Bangladesh from India; and exports of pharmaceuticals from India to Nepal). The study concentrates on measures relating to sanitary and phytosanitary standards (SPS) and technical barriers to trade (TBT), because these account for a majority of the nontariff barriers in South Asia. The study identifies procedural obstacles perceived by exporters in meeting SPS- and TBT-related NTM requirements, as captured through a survey. To distinguish between real and perceived issues, the information provided through the survey is triangulated with an assessment of the regulations and consultations with regulators in the three countries covered by the study.

The analysis underscores that information asymmetries are crucial in creating misperceptions, and a large part of the noise related to NTMs can be eliminated by dealing with information gaps. Another common theme is the delays stemming from inadequacies in border infrastructure and cumbersome procedures, such as those involved in product registration and renewal in the case of pharmaceutical products.

The report indicates several areas for policy consideration, targeting information flows, procedures, and infrastructure. Many of these can be seen as confidence-building measures that can pave the way for eventual mutual recognition agreements.

Information Flows

First, partners in South Asia could consider exploring a nontariff barrier resolution mechanism to enhance transparency and nudge the official system to settle NTM complaints more quickly. Drawing on the example of the mechanism set up by the African economic communities, such a system could include an online mechanism for reporting and monitoring complaints and hosted by an institution with some monitoring and evaluation capacity. This institution would provide traders with the necessary information to address their issues or to direct complaints to the relevant authorities within countries and continue monitoring each complaint until final resolution. Such an initiative would signal serious commitment to addressing nontariff barriers and could be an important step in reducing the trust deficit. A practical approach may involve establishing bilateral mechanisms and, based on demand, extend these to include other countries.

Second, partner countries could initiate information campaigns and workshops to reduce information asymmetry. For example, spreading awareness about the need for and procedures relating to pest risk analysis (PRA) on agricultural products, including medicinal and aromatic plants, would enable imports of such products into India. Requests for PRAs by importers in India and exporters in Bangladesh and Nepal could be fast-tracked under SAFTA/bilateral forums. This would also apply to other SAFTA countries.

Third, India as well as partner countries could spread awareness among exporters, importers, and regulators about all of the available public and private accredited laboratories in India. There has been historical dependence in India on only one public laboratory, namely, the Central Food Laboratory in Kolkata. This dependence continues to date because it is not widely known in Bangladesh, India, and Nepal that several laboratories in India now are accredited by the National Accreditation Board for Testing and Calibration Laboratories (NABL) and notified by the Food Safety and Standards Authority of India (FSSAI). Governments can develop marketing and communication strategies to familiarize traders with the various NABL-accredited and FSSAI-notified laboratories.

Procedures and Infrastructure

Fourth, establish a bilateral institutional mechanism to coordinate and expedite the FSSAI's notification of the partner country laboratories accredited by the NABL. It is not well known among traders and regulatory authorities in Bangladesh, India, and Nepal that test reports for food products issued by NABL-accredited laboratories in Bangladesh and Nepal are not accepted by Indian authorities unless these laboratories are also notified by the FSSAI.[1] Accordingly, it is suggested that an institutional mechanism be established bilaterally between the concerned countries so that notification by the FSSAI of NABL-accredited laboratories can be coordinated and expedited. This process would help ensure that food products imported into India are tested only on a random basis and help catalyze food trade, particularly agricultural trade, among countries in the region.

Fifth, introduce electronic data interchange, risk management systems, and single windows at more border points to enable realization of potential gains from coordination and efficiency. So far, electronic data interchange is operational between India and Nepal on one corridor along Kolkata to the Nepal border (Jogbani and Raxaul), while coordinated risk management has been introduced at the Bangladesh–India border (Petrapole/Benapole). Single-window systems at national levels have enabled greater coordination among agencies, thereby reducing transaction costs for traders. The FSSAI has been included in the single-window system and has introduced risk profiling to enable the system to identify high-risk consignments electronically. In general, electronic data interchanges can enhance risk profiling and are a prerequisite for single-window systems. Thus, if the goal is to achieve expedited clearance of food imports (with valid exporting-country test certificates recognized by India), electronic data interchange facilities need to be extended to other major land ports, such as Panitanki.

Sixth, streamline import procedures for pharmaceutical raw materials in Bangladesh and Nepal. Currently, product registration and requisite authorization processes, which are mandatory for pharmaceutical imports, are cumbersome and time-consuming in both countries. The Directorate General of Drug Administration (DGDA) in Bangladesh should streamline the process of product registration and reduce the time taken to register products and obtain requisite approvals. The pharmaceutical industry in Bangladesh would also benefit from this, given its heavy dependence on imports of pharmaceutical raw materials. Similarly, streamlining such processes in Nepal would benefit its local pharmaceutical industry.

THE HIGH COSTS OF CONNECTIVITY

A key obstacle to trade within South Asia is the disproportionately high costs of trading. The high costs arise from complex customs procedures, inadequate infrastructure at many border points, compliance costs associated with NTMs, and so forth. A key aspect of trade costs is connectivity, which depends on backbone transportation services between countries, such as air travel. The efficiency of air travel services can impact trade in goods because the transport of high-value, low-volume goods and trade in other services, such as tourism, health care, and education, often depend on air travel services. Moreover, the efficiency of air travel for business people can also affect FDI, and, ultimately, trade in goods and services.

Regional air connectivity within South Asia is restricted, and connectivity is poor even between capitals. Bilateral air connectivity is the best between India and Sri Lanka, which is a result of the progressive liberalization of air services between the two countries.

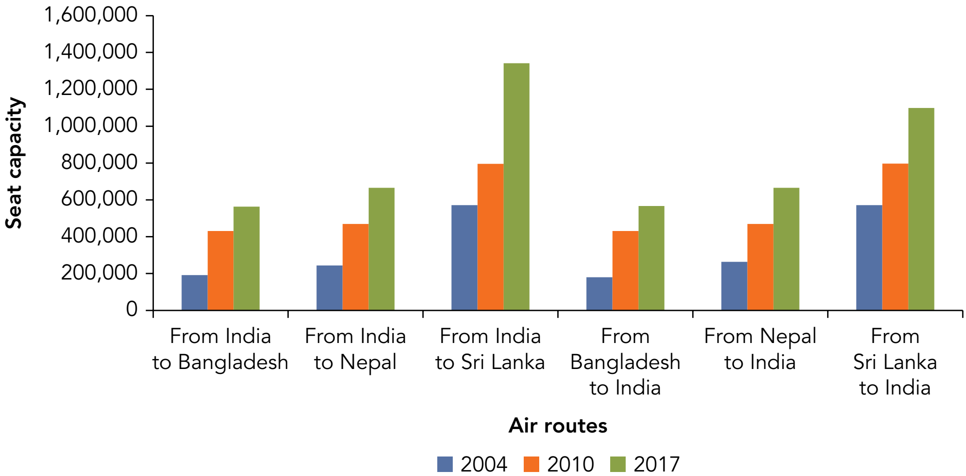
The report explores the issue of high connectivity costs in South Asia through the lens of air travel services by examining the liberalization of air services between India and Sri Lanka. The study tracks the evolution of the bilateral air services agreement (ASA) between India and Sri Lanka, focusing on the significant liberalization incorporated in the amendments of 2003 and 2011. The historical perspective is complemented by stakeholder interviews and econometric analysis to examine the impact of liberalization.

The first bilateral ASA between India and Sri Lanka, signed in 1948, has become progressively more liberal through decades of discussions, negotiations, and amendments. Although the agreement has not reached the status of a truly open skies arrangement, the major amendments of 2003 and 2011 have led to a freer bilateral air services market by allowing prices to be determined by the market, permitting private airlines to operate flights on bilateral routes, easing capacity limits and redefining them as flights per week rather than seats per week, and opening new destinations to bilateral air services.

The impact of the amendments of 2003 and 2011 on bilateral air services between India and Sri Lanka can be seen in the increase in the number of flights and seats between the two countries. During 2004–17, air services between India and Sri Lanka, in flights and seats, grew at a compound annual growth rate of about 6 percent. This bilateral air connectivity picked up pace after the end of the civil war in Sri Lanka in 2009: flights grew at 6.6 percent, and seats grew at 6.3 percent over 2010–17, more rapidly not only compared with the preceding years, but also relative to the air connectivity between India and Nepal (4.3 percent in flights and 5.1 percent in seats) and between Bangladesh and India (−1.3 percent in flights and 3.9 percent in seats) over the period. In 2017, air services between India and Sri Lanka continued to exceed, by a large margin, the services between the other two country pairs (figure O.4).

Econometric analysis applying a difference in differences approach reinforces the finding that the liberalization episode in 2011 had a positive effect on air connectivity

FIGURE O.4 Growth in Airline Seats Available between India and Selected Countries, 2004–17



Source: Based on data from DIIO (Data In, Intelligence Out) (database), Diio, LLC, Reston, VA (accessed August 2017), https://www.diio.net/products/index.html.

between the two countries. The resulting estimates indicate increases of 16 flights and 2,442 seats a week attributable to the 2011 reforms.

Cargo volumes also received a stimulus from the 2003 and 2011 reforms, but growth in cargo volumes was less pronounced and less robust compared with passenger traffic growth. This finding can be partly explained by the dominance of low value-to-weight products, not typically transported by air freight, in the bilateral trade between India and Sri Lanka.

The reforms also had a positive impact on competition and pricing. Although historical pricing data are unavailable, stakeholder interviews confirm that prices fell, initially by as much as 20–40 percent on routes where there was competition, but the declines were rolled back partially as SriLankan Airlines came to dominate the bilateral air services market, accounting for 80 percent of the supply capacity. Another indication of the decline in airfares is the rising market share of low-cost carriers in seats and flights, which suggests that average fares should have declined over the period (table O.3). Similarly, fares on the New Delhi–to–Colombo route are typically much cheaper than those on another comparable major route, New Delhi to Dhaka, despite the fact that the flying time on the latter route is one-third less. Overall, while the impact on competition and prices has been positive, it could have been greater.

The demand for air services between India and Sri Lanka has been shaped not only by reforms, but also several other events, such as the end of the civil war in Sri Lanka in 2009, the authorization of visas upon arrival for Indian travelers by the Sri Lankan government

TABLE O.3 India–Sri Lanka: Growth in Seats and Flights, Low-Cost Carriers, and Other Alliances
Average number per month

	Flights			Seats		
Carrier type	**2004–11**	**2011–16**	**Difference, %**	**2004–11**	**2011–16**	**Difference, %**
Other alliances	401	475	19	69,273	79,084	14
Low-cost carriers	51	85	67	6,956	11,430	64

Source: Data of DIIO (Data In, Intelligence Out) (database), Diio, LLC, Reston, VA (accessed August 2017), https://www.diio.net/products/index.html.

in 2003, and the implementation of the India–Sri Lanka Free Trade Agreement in 2000. Together, these have meant that India–Sri Lanka air traffic continues to be the most robust and exceeds all other bilateral air traffic in the region.

The aviation industry, especially in Sri Lanka, has been a major beneficiary of the air services liberalization and the other factors that have shaped bilateral air services. For example, by 2007, SriLankan Airlines was the largest foreign airline operating in India in flights per week (94), although other carriers became more dominant in subsequent years. The economic impact has reached far beyond the aviation industry. For instance, the tourism industry has benefited in both countries, though more in Sri Lanka. India had become the largest source country of foreign tourists in Sri Lanka by 2005. There has also been steady growth since 2003 in the number of Sri Lankan tourists arriving in India.

Overall, the gains from air services liberalization between India and Sri Lanka have been substantial and can be increased by spurring more competition on the routes between the two countries. Other countries in South Asia can learn from this experience and strive for deeper air services liberalization with each other bilaterally or regionally.

First, the study suggests that policy makers remain agnostic about the relative impact of liberalization on specific airlines, irrespective of country of origin, because they should focus on bigger prizes, including the benefits to consumers of more choice in flights and airlines, better customer service, and lower prices, which could encourage deeper trade and investment.

Second, a key lesson for policy makers in South Asia is the understanding that a gold standard, such as an open skies agreement (OSA), is not necessary to begin liberalization. An alternative is to adopt an incremental approach, as has been done by India and Sri Lanka, toward the goal of freeing up air services.

Third, gains can be reinforced if air services liberalization is accompanied by supporting reforms. The Sri Lankan government's authorization of visa-on-arrival privileges for Indian tourists complemented and may even have boosted the expansion in bilateral air services.

Fourth, there are grounds to suggest that, although the liberalization of air services between India and Sri Lanka has had a significant beneficial impact, the gains could have been greater. The structural weaknesses faced by the airlines of the two countries, partly reflected in the losses of their respective national carriers, constrained the capacity of the airlines to serve on bilateral routes. In general, the biggest weaknesses usually involve capacity constraints arising from the lack of aircraft and poor service quality. These can be addressed through management contracts and strategic alliances as alternatives to or in conjunction with foreign equity participation. The Indian government's progressive liberalization of foreign investment in the airline sector may offer some lessons to other countries in South Asia.

Fifth, the study highlights that it was in the interests of the government of Sri Lanka to keep pushing for deeper air services liberalization with India, given the relative size of India's market and the potential benefits to Sri Lanka of greater access to that market. This policy persistence has paid off for Sri Lanka, as documented in this report. Aviation authorities in other countries that still do not have liberal ASAs with India could keep this in mind, especially now that India's National Civil Aviation Policy 2016 offers a reciprocal OSA with the countries of the South Asian Association for Regional Cooperation (SAARC).

THE TRUST DEFICIT

Trust promotes trade, and trade fosters trust, interdependency, and constituencies for peace. In South Asia, the virtuous circle between trust and trade has been broken by a history of mutual mistrust rooted in historical conflict and size asymmetries across economies, which prevent South Asian countries from reaping the full economic benefits of geographical proximity and complementary resource endowments. The trust deficit and the negative stereotypes are perpetuated by a lack of people-to-people interactions.

Historic ties in areas along the Bangladesh–India border have meant that goods, especially essential agricultural commodities, have always been traded in these areas. However, once the hard borders were established, fenced, and strictly policed, much of the legal trade was truncated and replaced by informal trading and smuggling, some of which involved skirmishes.

An initiative by the governments of Bangladesh and India aimed at recapturing the once thriving economic and cultural relationships is now changing crossborder relations and reducing incentives for smuggling. This is occurring through haats, that is, local border markets. Based on detailed fieldwork in the four operational haats, as well as focus group and stakeholder discussions, this report analyzes the impact of haats on people-to-people relationships and trust building, as well as on employment and income generation in the local communities.

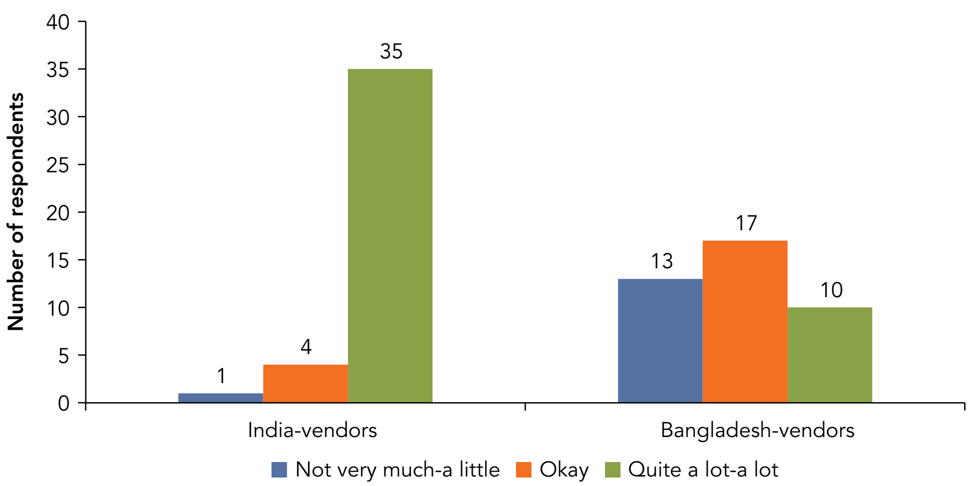
The study finds that border haats have had a disproportionately large and positive impact on welfare in local communities on both sides of the border through three channels:

- First, a gain in real income and the creation of livelihood opportunities, including among women and some of the most marginalized workers, as well as benefits for buyers
- Second, improved crossborder relations through deeper people-to-people contacts
- Third, a reduction in informal and illegal trading and the resulting peace dividend.

The border haats offer a significant supplementary source of income. Among Indian vendors, 97.5 percent saw substantial increases in income ("okay," "quite a lot–a lot"), while the corresponding share was 67.5 percent among Bangladeshi vendors (figure O.5). The haats have created jobs for transporters, laborers, and providers of ancillary services and boosted their incomes. These opportunities are also open to women, and, although uptake is affected by sociocultural constraints, women's participation can be encouraged by affirmative action, capacity building, better haat infrastructure, and easier access to the markets.

Border haats help consumers in rural border regions by providing a wider variety of goods at cheaper prices, goods for which there is inherent local demand and supply complementarity. Many of these goods are basic food items—otherwise less available throughout the year—and simple household goods.

FIGURE O.5 Ratings of Income Increases from Haat Trade



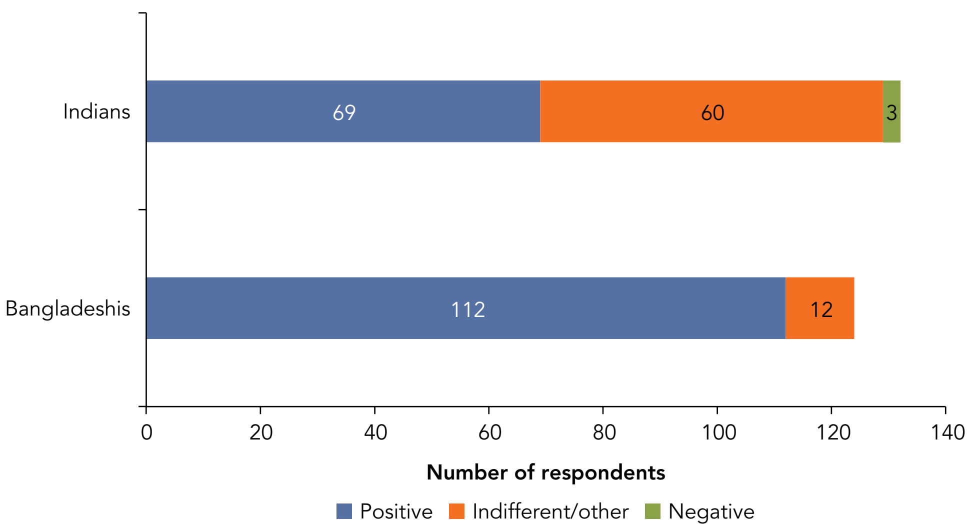
Source: Data from the India–Bangladesh border haats survey conducted by the Centre for International Trade, Economics, and Environment, Consumer Unity and Trust Society, Jaipur, India.

In supplying spaces for people to meet, reconnect, or establish fresh social and economic ties, the border haats have improved crossborder relations. Social mixing is a large part of what a haat offers. Groups of people with a shared history have reconnected, including some families that had been separated for years. Over half the Indian respondents have a positive view of Bangladeshis, and an overwhelming proportion of Bangladeshi respondents express a positive view of Indians (figure O.6), views they attribute to their exposure to their Indian neighbors at the haats.

Another positive impact of border haats has been a reduction in informal and illegal trading and the resulting peace dividend. Bangladesh–India border trade has always thrived, especially in essential agricultural commodities. According to Indian state government officials, informal trade was rampant before the border haats were created. In formalizing informal trade and reducing smuggling, the haats have contributed to the peace dividend and provided relief to agencies from the need for strict policing of these regions.

A few key messages and policy implications derived from the analysis are as follows. First, authorities could reflect on ways to scale up border haats systematically. The study shows clearly that border haat trade comprises a very small proportion of formal trade that would continue to be small even if the initiative is scaled up appreciably. Haat trade does not detract from formal trade, given volume limitations, which make it unattractive for more organized traders. It also has a disproportionately positive impact on the livelihoods of people in nearby border regions. It similarly provides a bigger peace- and relation-building dividend because of the face-to-face contacts involved

FIGURE O.6 The Views of Neighbors



Source: Data from the India–Bangladesh border haats survey conducted by the Centre for International Trade, Economics, and Environment, Consumer Unity and Trust Society, Jaipur, India.

among vendors, laborers, buyers on both sides of the border, as well as among officials. This represents a strong case for aggressive expansion in the number of border haats.

Second, authorities could streamline procedures, improve facilities, and enhance the use of technology. Most people who participate in the haats are poor or very poor. Even small gains can be valuable to them. Currently, the haats are characterized by poor sanitary facilities, especially toilets; lack of running water, including drinking water; and substandard approach roads. These shortcomings exert a disproportionate impact on women and the poor. All users of haats, including women and the poor, would benefit from steps to minimize theft, expand opportunities for productive activities, cut down on transport costs, and so on, steps that are spelled out in some detail in the study.

Third, a focus on value limits rather than limitations on products would help increase welfare gains. Products currently traded include fresh fruits and vegetables and also manufactured products produced by reputable companies. The product list might be expanded to provide initially for more locally made or grown products, followed by other products in high demand, which would boost the gains among both buyers and sellers. The purchase limits on buyers will ensure that trade volumes remain low and outside the mainstream.

Fourth, local and national authorities could consider ways to capitalize on the opportunities that haats offer to enhance women's participation. Unlike formal trade in South Asia, wherein women traders are not highly visible, the haats have enabled women, particularly in Meghalaya, to participate actively as vendors and buyers. Much more is possible, even in societies that are not matrilineal. The study offers several suggestions to boost women's participation and ease their access to haats through modifications in haat design, the choice of location of new haats, operational guidelines to streamline the functioning of haats, capacity building for wider participation in haats, and infrastructure upgrading.

Fifth, countries in South Asia could deliberate on the possible replication of the haat experience in the context of other land borders in the region, given the unambiguously positive experience of border haats in Bangladesh and India.

A Synopsis

The objective of this report is to document systematically the gap between current and potential trade in South Asia and address important specific barriers that have held trade back. These barriers include tariffs and paratariffs, real and perceived nontariff barriers, connectivity costs as manifest in the cost of air travel, and the broader trust deficit.

Much of the literature has addressed the obstacles to trade from a higher-level perspective and provided policy suggestions at a similar level of aggregation. However, such broad guidance does not seem to have catalyzed any significant momentum in South Asia toward removing critical policy obstacles.

This policy-focused report therefore pursues a different approach, undertaking in-depth studies on a curated list of barriers to trade and investment within South Asia that reflect the broader obstacles. The main focus is on four areas: tariff and paratariff barriers to trade; complicated and nontransparent NTMs; the disproportionately high costs of trade, especially because of poor transportation and logistics infrastructure, inefficient customs and border procedures, and poor intraregional connectivity; and the trust deficit in the region because of historical conflicts and size asymmetries. This approach is more pertinent to precise, actionable recommendations that are useful for policy makers.

The studies of four specific barriers described in this report are based on detailed knowledge gathering. Two are based on specific surveys and data collection, one of which includes focus group discussions; one is based on extensive stakeholder consultations; and the fourth has involved an analysis of tariffs, including new data on paratariffs. Two of the four studies (on air travel and border haats) highlight success stories and the related lessons.

Along the way, the report also documents experiences from around the world that clarify the motivations behind integration among various regional actors. Through an enumeration of the gains from existing trade, it illustrates current trade patterns and the potential benefits that deeper trade integration could help realize. It marshals new analysis that shows how trading regimes in South Asian countries discriminate against each other. It highlights the substantial problems in South Asia deriving from the lack of normal trade relations between the two largest economies in the region, India and Pakistan, and the special trading difficulties of transit and landlocked countries and subregions. It also illustrates the substantial advantages that could accrue to consumers, producers, exporters, and investors from more effective regional trade integration.

The South Asia trade integration strategy advocated in this report, like all trade reform, would create winners and losers. This calls for careful management of implementation. A sustainable process of trade integration, irrespective of the actors with whom a country is entering into a deeper partnership, will require the following ingredients:

- Precisely articulating the trade strategy, with timelines for reforms of all border taxes, communicated clearly and transparently to stakeholders
- Phasing in trade liberalization in sectors where there are concerns about large job displacement
- Implementing a strategy to diversify sources of tax revenue that would reduce the often substantial dependence on trade taxes
- Focusing on critical reforms that would help the economy and the private sector take advantage of trade liberalization, including improving trade facilitation, attracting high-quality FDI, and addressing key issues that constrain the ease of doing business

- Negotiating enhanced market access within South Asia and in selected critical markets, especially in East Asia, which are underrepresented in the export basket of South Asian countries
- Strengthening safety nets and training among those workers whose jobs are affected
- Improving the links among education, training, and the job market to supply better skills to the sectors that gain from trade reform
- Defining a limited fiscal package with clear and transparent criteria for the firms or sectors that will be adversely affected by trade reforms.

Note

1. In April 2017, the FSSAI authorized the Bangladesh Standards and Testing Institution (BSTI) to issue certificates of test analyses for 21 food products. See "Orders and Guidelines on Imports of Food Articles," Food Safety and Standards Authority of India, New Delhi, http://fssai.gov.in/home/imports/order-guidelines.html.

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Recently, significant progress has been made in specific areas for improving the enabling framework for boosting regional trade. The future holds considerable promise as Sri Lanka negotiates to deepen its free trade agreement (FTA) with India and considers an FTA with Bangladesh. This publication provides readers with excellent and insightful analysis of the opportunities and changes that need to be addressed to fulfill the potential for a transformative impact in regional trade.

— Indrajit Coomaraswamy, Governor, Central Bank of Sri Lanka

The South Asian region contains many of the world's poor. While other regions have integrated themselves through trade, investment flows, and connectivity, South Asia lags far behind. This highly illuminating study based on empirical work demonstrates that it is not rhetoric but very much in the realm of reality that trade and connectivity can generate huge gains for all the countries in the region. Policy makers in these countries are well advised to listen to this sane advice and work to bring large untapped benefits for the poor of this region.

— Ishrat Husain, former Governor, State Bank of Pakistan and Professor Emeritus Institute of Business Administration, Karachi

This report meticulously analyzes the key barriers to achieving greater South Asian economic integration, which has remained far below potential. Remarkably, the report finds that despite a regional free trade agreement, South Asia has more restrictive trade within the region than with the rest of the world. Based on in-depth case studies of reaping the benefits of regional trade, the report comes up with key practical policy directions that demand the attention of policy makers and the informed public.

— Wahiduddin Mahmud, former Professor of Economics, University of Dhaka, and Chairman, South Asian Network of Economic Research Institutes (SANEI)

This book fortified my belief that women-to-women trade is key to achieving regional integration and peace in South Asia. The rich case study on India-Bangladesh border haats shows how haats can create trade and empower women. The key policy recommendations in the book for scaling up and replicating such cross-border regional initiatives deserve serious consideration.

— Reema Nanavaty, Director, Self-Employed Women's Association of India (SEWA)

Creating a zone of stability, peace, and prosperity in South Asia—one of the world's hot spots—is a major challenge for the world and an existential imperative for India. This terrific report carefully, insightfully, and convincingly shows that regional integration can play a critical role in meeting that challenge.

— Arvind Subramanian, former Chief Economic Adviser, Government of India

This book shows with compelling fresh evidence how—by chipping away at soft and hard barriers that restrict the flow of goods, capital, ideas, and people—the region can regain its promise of becoming a global economic dynamo. The book is a vital resource for a new generation of policy makers who are unencumbered by the past and keen to steer South Asia toward greater wealth and human security in the 21st century.

— Swarnim Waglé, former Vice Chair, National Planning Commission, Nepal

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