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India-Pakistan Trade: A Roadmap for Enhancing Economic Relations

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Many previous attempts to improve economic ties between India and Pakistan unfortunately have been derailed by periodically heightened political tensions between the two countries—be it Kargil in May 1999, the terrorist attack on the Indian Parliament in December 2001, or most recently, the Mumbai attacks in November 2008. Although successive Indian and Pakistani governments have often repeated the desire for peaceful relations, reaching a comprehensive agreement that settles outstanding disputes still seems far off. But this does not mean that steps toward better economic relations cannot be taken. Indeed, there was a major breakthrough in trade relations at the meeting between then President Pervez Musharraf of Pakistan and Prime Minister Manmohan Singh of India in New Delhi in April 2005 (Joint Communiqué 2005). A number of trade-related issues were discussed at this meeting, and several key decisions were taken to move the process along.

On the face of it, the Musharraf-Singh 2005 meeting was probably one of the most important meetings between India and Pakistan on trade issues and generated considerable optimism on both sides of the border about overall trade relations in the future. However, four years later most of the decisions are being implemented very slowly, if at all, as political tensions, security issues, and domestic political opposition to the agreements continue to create obstacles. But now with a new Indian government and a relatively new democratically elected government in Pakistan, the timing may well be propitious to revive and expand the "confidence-building" actions on the trade front that came out of the famous April 2005 summit. While the Mumbai attacks severely strained relations between the two countries, Prime Minister Manmohan Singh and President Asif Ali Zardari had their first post–Mumbai attacks meeting on the sidelines of a regional summit in Yekaterinburg, Russia, on June 16, 2009, and a further meeting is planned at the Non-Aligned Movement Summit in Egypt in July. Both leaders have stressed that it is in the vital interest of the people of the subcontinent to have peace, and are apparently ready to engage on economic issues. Improving economic ties may help to resolve the larger political issues that have bedeviled India-Pakistan overall relations for over 60 years.[1]

The potential gains from increased economic integration between India and Pakistan are large. Trade between the two countries is unnaturally small and the scope for gains from

1. This has been stressed, for example, by Khan et al. (2007). See Murshed and Mamoon (2008) for a discussion of the various issues that have divided the two countries.

increased trade correspondingly large.[2] Currently, official trade is about $2 billion per year, up from a paltry $300 million a year in 2003–04.[3] But still Pakistan accounts for less than 1 percent of India's trade and India accounts for under 5 percent of Pakistan's trade compared with the very large trade shares following independence of the two countries in 1947: In 1948–49, 70 percent of Pakistan's trading transactions were with India, while 63 percent of Indian exports went to Pakistan. Estimates from gravity models suggest that trade between the two countries could be 5 to10 times larger than the present $2 billion per year, thereby raising GDP and household incomes in both countries.[4] Informal trade, via third countries (such as the United Arab Emirates, specifically Dubai), is estimated at some $2 billion to $3 billion per year, and this trade could obviously be undertaken bilaterally at significantly lower cost.

Improving economic ties may help to resolve the larger political issues that have bedeviled India-Pakistan overall relations for over 60 years.

Constraints on economic integration include high tariff and nontariff barriers, inadequate infrastructure, bureaucratic inertia, excessive red tape, and direct political opposition. Pakistan has not yet reciprocated most favored nation (MFN) status for India and maintains a fairly narrow positive list (786 items) on goods that India may export to Pakistan. At the same time, India's tariff rates remain high, especially for goods of particular interest to Pakistan, such as textiles, leather, and onyx, and nontariff barriers are substantial. Poor transportation linkages make trade costly, with railway and road connections inadequate and sea shipments constrained by both limited port facilities and bureaucratic regulations and restrictions. Moreover, constraints on visas and cumbersome payments and customs procedures further limit scope for trade. Finally, although there are no specific restrictions, there is virtually no trade in services or foreign direct investment (FDI) flows between the two countries. In both the cases of services and FDI, prior government approval has to be obtained, and it is clear that such approvals have been granted very sparingly by either country.

A STRATEGY FOR INCREASING TRADE

Before undertaking more long-term fundamental reforms, both countries need to build public support for trade liberalization. Initial steps should focus on bilateral measures that can be accomplished relatively easily—by executive order rather than via legislation and with minimal resource implications—and that would meaningfully increase trade while gaining support for bigger and bolder steps down the line. While a few of the measures proposed here fall under the ambit of the World Trade Organization (WTO) and have to be handled in a multilateral setting, most would involve only bilateral agreements between the two countries.

Appendix 1 presents a summary of the main tariff and nontariff barriers to trade between India and Pakistan. Reducing these barriers and eventually achieving regional integration could involve two phases: short term (6–12 months) and medium term (1–3 years).

First Phase: Short-Term Measures

Many of the short-term measures proposed here were agreed in principle at the Musharraf-Singh meeting. However, the agreements were limited in scope and, even so, were not fully implemented. Since the issues are well known and have been discussed at length by both sides, it should be possible to move ahead rapidly on expanding and implementing the measures if the political will is there. The specific short-term measures, mainly relating to trade facilitation, could include:

- Easing restrictions on visas, specifically, allowing multiple-entry visas for businessmen, eliminating requirements to report arrival to the police at each place of stay, eliminating city-specific visas, and speeding up the approval processes;
- Signing a protocol to permit Indian/Pakistani ships to lift cargo for third countries and eliminating the reciprocal requirement that ships touch a third-country port before bringing in imports. The third-country port restriction particularly affects trade of high-bulk, low-value goods, such as coal, tar, and cement, making their transportation via sea commercially unviable. Also allowing sea shipments in addition to the current Mumbai-Karachi route;

2. As noted by the Confederation of Indian Industry (2005), Mukherjee (2005), Nabi and Nasim (2001), and Taneja (2006), among others. A very useful description of Pakistan's trade relations with its South Asian neighbors, particularly India, is contained in Hufbauer and Burki (2006, appendix A).

3. As a point of reference, India and Sri Lanka have had a free trade agreement (FTA) since 2000, and total Indian–Sri Lankan trade is about $3 billion, even though Sri Lanka's GDP is roughly a quarter that of Pakistan. Sri Lanka and Pakistan also signed an FTA in July 2002, which became operational in 2005.

4. This is based on the estimates made by Batra (2004) and Kemal, Abbas, and Qadir (2002).

- Eliminating the reciprocal requirement that rail wagons carrying goods across the border return empty, increasing the frequency of rail traffic, and improving the coordination between the railway authorities. Businessmen have suggested restarting the old Sindh-Rajasthan rail link;
- Opening additional border crossings, increasing traffic frequency on the road route through the Wagah border (connecting the major cities of Amritsar and Lahore)[5] and the Khokhrapar-Munabao route, and allowing increased traffic through the Srinagar-Muzzafarabad route, which is currently restricted to only four trucks from either side crossing once a week;
- Opening additional bus routes. The Musharraf-Singh meeting in April 2005 yielded a commitment to increase the frequency of the cross-Kashmir bus service via the Srinagar-Muzzafarabad route. However, the bus service is only weekly and restricted to passengers who have relatives on the other side of the border;
- Increasing air links between the two countries. Currently, the only air links agreed are Lahore–New Delhi, Karachi–New Delhi, and Karachi-Mumbai. There is no direct air link between the two capitals (Islamabad–New Delhi);
- Increasing the number of customs posts where "sensitive" items can be cleared and eliminating requirement for 100 percent verification; and
- Allowing branches of Indian and Pakistani banks to operate in the other country and allowing banks in one country to hold accounts in the currency of the other.

Second Phase: Medium-Term Measures

The short-term measures outlined above should provide the stepping stones to move to more fundamental reforms in trade relations between the two countries. Over the medium term, the key measures would be for Pakistan to grant MFN status to India, which India has already provided to Pakistan, and allow transit trade from India. These would be accompanied by India reducing tariff rates on goods of particular interest to Pakistan and removing nontariff barriers, including in agriculture. The authorities should also seek to agree on steps to harmonize—or at least make more transparent—customs procedures and product standards. To the extent that regulations or government practices constrain FDI and services trade, an end to these constraints should be negotiated. Eliminating double taxation would also boost the attractiveness of cross-border investments. These steps would greatly expand the scope of integration, with potentially large efficiency gains on both sides.

Constraints on economic integration include high tariff and nontariff barriers, inadequate infrastructure, bureaucratic inertia, excessive red tape, and direct political opposition.

The South Asian Free Trade Agreement (SAFTA), which came into effect in January 2006, provides a framework for removing some obstacles to trade, but its implementation alone would likely not dramatically improve economic integration. SAFTA calls for tariff rates within the region to decline to zero by 2012, but it is highly unlikely that this target will be met. Currently, tariff rates in India are significantly higher than those in Pakistan (appendix 1). In particular, India's high tariffs on agricultural products and textiles severely discourage Pakistan's exports to India. The Pakistanis believe that these tariffs are implicitly targeted at their country, whose potential exports would mainly include these two items (e.g., cotton yarn and fruits and vegetables).[6] Beyond this slow pace of tariff reductions, benefits will depend on exactly how the agreement is implemented. In particular, an agreement with fewer and simpler rules of origin and small negative lists would be beneficial. However, the negative lists in both countries are thought to be quite extensive. Moreover, SAFTA does not cover services and investments.[7] Thus, broader bilateral measures remain very important.

Finally, infrastructure in both countries needs to be significantly improved and harmonized: Roads need to be expanded and upgraded, and ports need to be modernized. Both countries are seeking ways within their overall fiscal constraints to move rapidly on these fronts. Improving regulatory frameworks for key infrastructure sectors would help attract the private sector to participate in improving infrastructure in both countries. In addition, the scope for trade in

5. The Attari-Wagah border closes at 2pm every day in preparation for the "retreat" ceremony when Indian and Pakistani flags are lowered at sunset. Therefore, an alternative, possibly parallel, truck route is needed.

6. In addition to pharmaceuticals, medical equipment, and sporting goods.

7. Unlike in the case of goods, under the WTO rules, countries maintain a positive list of services for trade. Pakistan has such a positive list, but it does not discriminate against India.

energy appears to be sizeable, and eventually both countries could work on developing a joint energy grid.

The specific medium-term measures toward greater economic integration between India and Pakistan could include:

- Within the framework of SAFTA, Pakistan should agree with India on as limited as possible lists of sensitive items. Both Pakistan and India should apply MFN duty rates to items on the sensitive lists.

- India should significantly lower tariff rates for goods of particular interest to Pakistan (e.g., textiles, leather, and onyx) and remove nontariff barriers. In return, Pakistan should follow WTO rules and reciprocate by providing MFN status to India and abolishing the positive list approach.[8]

- Pakistan should allow transit trade from India. WTO rules require Pakistan to allow transit trade for all goods to and from third countries (including Afghanistan and the countries in Central Asia). Pakistan views this as problematic because of the risk that goods "dumped" by India in Afghanistan will reenter Pakistan, and as such transit trade from India has been restricted.

- Energy trade between the two countries should be facilitated. The greatest benefit would occur in the sphere of energy cooperation. To start with, the countries could agree on the gas pipeline between Iran and India passing through Pakistan. This would assure India of a regular supply of gas, and Pakistan would earn transit fees (estimated at about $800 million a year), in addition to meeting its own energy needs. While recognizing the geopolitical problems associated with this particular project, specifically US opposition in the context of sanctions against Iran, it should be noted that Iran and Pakistan have recently reached agreement on a gas pipeline, so the necessary infrastructure up to India's border will be in place. Of course, it would require the United States to waive its Iran sanctions for India to agree to proceed with the project. In the longer term, the development of joint energy grids, particularly in the Punjab-Haryana and Sindh-Rajasthan regions, would create efficiencies through economies of scale and lower energy costs for both countries.

- Both countries should also allow trade in information technology (IT). Despite India being well ahead of Pakistan in this field, both countries could engage in mutually beneficial business-to-business links. Since IT trade does not involve movement of goods, it would be easier to move ahead quickly in this area. For example, Pakistan could allow large Indian IT companies to set up call centers and other IT-related firms, taking advantage of the existing (and growing) English-speaking workforce in Pakistan.

- Both countries should harmonize their customs procedures, including more standardized and transparent documents and inspection procedures and product standards. Also, sanitary and safety laboratory inspections in one country should be accepted in the other.

- Obstacles to FDI flows, other than restrictions based on national security grounds, in both directions should be eased and obtaining government approval streamlined. Each country's companies should be allowed to float shares in the securities markets of the other, and double taxation on corporate and individual incomes should be removed.

CONCLUSION

With new governments in both India and Pakistan, there is once again a window of opportunity to improve economic ties. While the measures for reducing trade barriers proposed in this brief generally have the support of businessmen on both sides of the border, it is critical to build constituencies in each country for greater bilateral trade liberalization.[9] The success of the "confidence building" short-term measures and the resulting growth in trade would give a major impetus to the creation of vested interests that would support more far-reaching liberalization of trade between the two countries. Only then will the political and bureaucratic opposition to increased India-Pakistan trade be diminished. Trade will of course not solve all the problems between the two countries, but it could be an important catalyst in the lowering of tensions. And a lowering of tensions between India and Pakistan—an inevitable benefit of strengthened economic ties—would improve the security climate for investment and economic development in both countries. It is clearly in the interest of both countries, and the world for that matter, to find a political resolution to the India-Pakistan problem, and increased trade can well be the starting point for this objective. In the case of India-Pakistan trade relations, good fences do not make good neighbors!

8. The view of some Pakistani politicians and bureaucrats is that MFN status for India should be linked to the resolution of the Kashmir issue. Interestingly, this view is not necessarily shared by the Pakistani business community, which argues rightly that trade should not be held hostage to the Kashmir solution.

9. Earlier fears in Pakistan that Indian exports would overwhelm the domestic production of manufactures have eased over time as Pakistani businessmen have realized that they can compete in a number of areas, such as agro-industry products, textiles, and surgical instruments, if there is a level playing field.

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Appendix 1 Barriers to trade between India and Pakistan

Barriers to trade	India	Pakistan
	Tariff barriers	
Most favored nation (MFN) status	Has granted MFN to Pakistan.	Not granted MFN to India; imports from India restricted to positive list (786 items); most of the permissible items are chemicals, minerals, and metal products; finished products are not part of the list; no special restrictions on exports to India.
Unweighted average customs duty	22.2 percent	14.9 percent
Nonagriculture	19.7 percent	13.8 percent
Agriculture	40.1 percent	20.5 percent
General maximum customs duty	30 percent (20 percent, excluding agriculture).	25 percent
Special higher duties	For 18.5 percent of tariff lines: rates of 35 to 182 percent (agriculture, automobiles, textiles, and garments).	For 1.1 percent of tariff lines: rates of 40 to 250 percent (edible oil, automobiles, and alcohol).
	India has extended tariff concessions to Pakistan on 393 items.	Pakistan has extended tariff concessions to India on 248 items; until recently 78 of these items could not be imported because they were on the banned list, but these items have since been added to the positive list.
	Nontariff barriers	
Import licensing	Dismantled; no registration, licensing fees, and quotas.	Dismantled; no registration, licensing fees, and quotas.
Subsidies	India provides significant subsidies to producers and consumers (mainly in agriculture).	Few subsidies except urea fertilizer and electricity to households, but subsidies through support prices (wheat and cotton).
Visa regimes	Very restrictive; visas take a long time to process and for a particular city, Pakistani nationals are required to register themselves upon entry into India and also have to report their arrival to and intended departure from each place of stay as permitted on the visa within 24 hours at the nearest police station.	Very restrictive for Indians; police reporting required, but recently, some relaxation has occurred, with multiple-entry visas being granted to Indian businessmen when arranged through the Chambers of Commerce.
Land transportation	Few border crossings; very limited rail traffic across borders; and requirement that rail wagons carrying goods across the border should return empty.	Few border crossings; very limited rail traffic across borders; and requirement that rail wagons carrying goods across the border should return empty.
Air travel	Still limited, but some improvement in recent years.	Still limited, but some improvement in recent years.
Sea transportation	Ships must first touch a third-country port to import from Pakistan (i.e., Dubai or Singapore); limited ports and inland customs posts at which the import of "sensitive" products can be cleared.	Ships must first touch a third-country port to import from India (i.e., Dubai or Singapore); Pakistan has only one major port in operation (Karachi).
Payment systems	No branches of Indian banks in Pakistan; payments for exports/imports have to be made through third-country banks.	No branches of Pakistani banks in India; payments for exports/imports have to be made through third-country banks.
Energy trade	No energy trade with Pakistan.	No energy trade with India.
Services/information technology (IT)	Trade with Pakistan in services and IT is heavily restricted.	Trade with India in services and IT is heavily restricted.