

India-Bangladesh Bilateral Trade and Potential Free Trade Agreement

Bangladesh Development Series
Paper No: 13

The World Bank Office, Dhaka

December, 2006

www.worldbank.org.bd/bds



Document of the World Bank



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CURRENCY EQUIVALENTS

US \$1.00 = Tk 69.36 (Bangladesh Taka, August 2006)

GOVERNMENT'S FISCAL YEAR

July 1 – June 30

Acronyms and Abbreviations

AD	Anti-Dumping	MFN	Most Favored Nation
AIT	Advanced Income Tax	NBR	National Board of Revenue
AV	Assessable Value	NCAER	National Council of Applied Economic Research
BEI	Bangladesh Enterprise Institute	NTB	Non Tariff Barrier
BIDS	Bangladesh Institute of Development Studies	POL	Petroleum, Oil and Lubricants
BIS	Bureau of Indian Standards	PSI	Pre-shipment Inspection
CD	Customs Duty	QR	Quantitative Restriction
CIF	Cost, Insurance and Freight	RD	Regulatory Duty
DEPB	Duty Exemption Pass Book	REER	Real Effective Exchange Rate
DGFT	Director General of Foreign Trade	RMG	Ready Made Garments
EPB	Export Promotion Bureau	ROW	Rest of the World
EU	European Union	SAARC	South Asian Association for Regional Cooperation
FCI	Food Corporation of India	Saad	Special Additional Duty
FDI	Foreign Direct Investment	SAFTA	South Asia Free Trade Agreement
FOB	Free on Board	SAPTA	SAARC Preferential Trading Agreement
FTA	Free Trade Agreement	SD	Supplementary Duty
GDP	Gross Domestic Product	SEDF	South Asia Enterprise Development Facilities
HS	Harmonized Code	SPS	Sanitary and Phyto-sanitary
IDSC	Infrastructure Development Surcharge	STE	State Trading Enterprise
LC	Letter of Credit	T&C	Textile and Clothing

LDC	Least Developed Country	TRQ	Tariff Rate Quota
LF	License Fee	VAT	Value Added Tax
M&B	Men and Boys	WTO	World Trade Organization

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Volume II - Technical Annex:

Methodology and selected case studies: *This Technical Annex is made available on a CD-Rom attached to this report.*

Acknowledgements

This report was prepared by Garry Pursell (consultant, SASPR) and Zaidi Sattar (SASPR). Component studies on various aspects of India-Bangladesh trade were made by Abdul Bayes, Sanjib Pohit and Samanthak Das, Rajesh Mehta, Arun Goyal and Ashu Garg (consultants). Data International conducted field survey on informal trade while Ziaul Ahsan compiled and analyzed essential data and provided superb general research support. Subject to time and other constraints, the authors did their best to take account of suggestions made by Aaditya Mattoo, Will Martin, Paul Brenton, David Tarr, Phillip Schuler (all at Bank headquarters in Washington), and many insightful and thoughtful detailed comments received from peer reviewers Marcelo Olareaga, I.N. Mukherjee (India), Zaid Bakht and Ismail Hossain (Bangladesh). The report was prepared under the overall guidance of Sadiq Ahmed, Shanta Devarajan, and Alastair J. McKechnie. Ijaz Nabi and Ejaz Syed Ghani provided useful oversight and direction when they were needed. In the World Bank Dhaka office Aneeka Rahman and Nermeen Shams Rouf provided research support while Mehar Akhter Khan and Mildred Gonsalves put the report together and skillfully formatted the voluminous text in record time. The study also relied on secretarial support at various stages from Oxana Bricha (Washington), Jyoti Sriram (Delhi) and Joyce Mormita Das (Dhaka). The report was produced by Rehnuma Amin and Erwin De Nys. Lastly, the authors would like to express their appreciation to Suman Bery (NCAER) and Farooq Sobhan (BEI) for sponsoring the Dhaka and Delhi workshops, and to the many government officials, businessmen, academics, researchers, and others in India and Bangladesh, who attended and provided feedback, essential information and guidance during the preparation of this report. Finally, the cooperation and support of SEDF for the workshops is gratefully acknowledged.

The report has been discussed with the Government of India and Government of Bangladesh but does not necessarily bear their approval for all its contents, especially where the Bank has stated its judgments/opinions/conclusions/policy recommendations.

Foreword

Bangladesh and India have long shared the common objective of fostering closer economic integration within the South Asia region. However, there are few analytical studies that describe the likely impact of such integration. The present report attempts to fill this gap.

While bilateral trade between the two countries has been growing steadily since the early 1990s, exports from India far outweighed imports from Bangladesh, resulting in a yawning trade gap. Only recently, this trend is showing signs of abating with a strong pick up in Bangladesh exports, thanks to tariff concessions from India and removal of other trade barriers with mutual agreement. The signing and ratification of South Asia Free Trade Agreement (SAFTA) in early 2006 by the two countries sets forth the possibility of further consolidation of trading arrangement through the formation of bilateral Free Trade Agreement (FTA).

Critical concerns on the Bangladesh side include the massive trade deficit with India and the large volumes of informal imports from India across the land border which avoid Bangladesh import duties. For India, although trade with Bangladesh currently is small, the potential of Bangladesh as an emerging market on India's borders will evince great interest for the business and investor communities. In addition, closer economic ties with Bangladesh are seen as a very important way of reducing the economic and political isolation of the seven Indian eastern and north eastern states from the rest of the country. A bilateral FTA could create the scope for resolving some of these critical issues while removing some vexing tariff and non-tariff barriers.

What would be the implications of a bilateral free trade agreement for both Bangladesh and India? The present report seeks to answer these critical questions by analyzing different aspects of India-Bangladesh trade, and, by using industry case studies, tries to measure the potential benefits and costs of a Free Trade Agreement between the two countries.

The study, completed with research contributions from both sides of the border, finds that a FTA will bring large welfare gain for consumers in Bangladesh provided there is adequate expansion of infrastructure and administrative capacity at custom borders. Yet the benefits of such a FTA to Bangladesh could be wiped out if it has the effect of keeping out cheaper third-country imports, say, from East Asia. Such trade diversion costs can be huge and the only way to minimize them is through further unilateral liberalization. For India, since trade with Bangladesh is small relative to its total trade, welfare gains from a FTA will be modest, though it could trigger cross-border investment opportunities.

Nevertheless, the study finds a weak case for pursuing a bilateral FTA based on the potential economic benefits to both countries. Instead, it argues that unilateral trade liberalization by both countries would yield much larger economic benefits whilst minimizing risks. Thus in order to get mileage out of a FTA, both countries are advised to continue with unilateral liberalization while streamlining border transactions through trade facilitation.

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Executive summary

The trading relationship between India and Bangladesh is currently of special interest in both countries for a number of reasons. Firstly, there are urgent and longstanding concerns in Bangladesh arising from the perennial, large bilateral trade deficit with India, and from the large volumes of informal imports from India across the land border which avoid Bangladesh import duties. These concerns have been particularly acute on the Bangladesh side in the context of discussions between the two governments of the possibility of a bilateral free trade agreement along the lines of the India-Sri Lanka FTA. Secondly, even though (because of the disparity in the size of the two economies) India's trading relationship with Bangladesh is much less significant for it than it is for Bangladesh, closer economic integration with Bangladesh is nevertheless seen as a very important way of reducing the economic and political isolation of the seven Indian eastern and north eastern states from the rest of the country. Finally, both countries have long shared common objectives for closer economic integration within the South Asia region, and these have recently been reemphasised by signing on to SAFTA, which takes effect from January 2006. Under SAFTA, the preferential tariffs agreed in the various rounds of SAPTA-- so far largely ineffective in generating much intra-regional trade-- will continue, but a number of ambitious new objectives have been enunciated. These include the eventual elimination of tariffs and non-tariff barriers on trade between the members, the harmonisation of Customs procedures and documentation, the facilitation of banking relationships, and cooperation and improvements in the infrastructure for regional trade and cross-border investments¹.

This report summarizes and attempts to draw out and synthesize some of the main conclusions of a series of consultant papers on various aspects of the trading relationship between India and Bangladesh. The study program originally also included a component which involved a summary and overview of the current situation on trade policy in each of the five principal South Asian countries (India, Pakistan, Bangladesh, Sri Lanka and Nepal) plus Bhutan and Maldives. This component became a major separate study, the results of which were published in a three volume World Bank report in September 2004 (*Trade Policies in South Asia: an Overview*) and which were discussed in a series of workshops in the region.

Background: bilateral trade and exchange rates

In 2004 India's officially recorded exports to Bangladesh were about \$1.7 billion but its imports from Bangladesh were just \$78 million. Since 1996/97 Indian exports to Bangladesh (in nominal US dollars) have been growing at 9.1% annually, just slightly above the general rate of growth of its total merchandise exports (8.4%), but India's imports from Bangladesh over the same period have grown on average at only 3% annually, compared to average growth of its total imports of 9.2%. Consequently Bangladesh's bilateral trade deficit with India has been increasing rapidly, on average at about 9.5 % annually. However, the bilateral trade deficit narrowed for the first time in fiscal 2005/06, when Bangladesh's exports rose to \$242 million from \$144 million in the previous year, while India's exports fell to \$1.8 billion from \$2 billion in FY2004/05.

For India, trade with Bangladesh is a very small part of its total trade--just over one percent since the mid-1990s, and currently about 3 percent of its total exports and a miniscule share (0.01%) of its total imports. For Bangladesh, however, India has now become the largest single source of its imports (about

¹ Under the Trade Liberalization Program of SAFTA, India pares down its tariffs to 0-5% by 2013 while Bangladesh has until 2016 to do the same, subject to exclusion of sensitive lists (India's 763 tariff lines versus Bangladesh's 1254, at the 6-digit level).

15% of the total, ahead of China and Singapore) and accounts for about a tenth of its total trade, despite exports to India which have declined to only slightly above 1 % of total exports.

Most Bangladesh imports from India come via the land border. According to incomplete Bangladesh data, during the 1990s about three quarters of imports were by land and river, but this proportion has declined since then to between 50 and 60 percent. Two reasons for the decline in the share of the land border trade are:

- A requirement imposed by Bangladesh in July 2002 that two major imports from India-sugar and textile yarns-could henceforth only be imported by sea. The reason given for these measures was the control of illegal activities and smuggling at or near the land border Customs posts².
- Increasing congestion and delays at the land border crossings-especially at Petrapole-Benapole-as a result of inadequate infrastructure and administrative capacity on both the Indian and Bangladesh sides.

Studies of informal trade between India and Bangladesh have consistently found a pattern similar to that of formal trade i.e. large volumes of goods being smuggled from India to Bangladesh, but much smaller volumes being smuggled in the other direction. This general conclusion that there is also a substantial Indian trade surplus on informal account, is confirmed once again in the studies done as part of this project. The study finds that apart from cross border smuggling, the practice of over- and under-invoicing in formal trade makes a significant contribution to the volume of informal trade.

The appreciation of the real Taka/Rupee exchange by about 50% between mid-1980s up to about 1999, would have contributed to the expansion of both formal and informal Indian exports to Bangladesh, and retarded the growth of Bangladesh exports to India. However, recorded Bangladesh imports from India have grown even more rapidly since the exchange rate trend was reversed after 1999, and Bangladesh exports to India have continued to stagnate. Two possibilities arise: (a) faster productivity growth in India increased the difficulty of Bangladesh exports competing there, offsetting the favourable trend in the exchange rate since 1999; (b) significant tariff and non-tariff barriers constraining Bangladesh's major exports (RMG) or minor exports which have experienced rapid growth elsewhere.

A nation's overall trade deficit, rather than a bilateral trade deficit, is what matters. Bangladesh's trade deficit with India has been consistently offset by trade surpluses with other countries, especially with the US and the EU, and by worker remittances. These surpluses have in turn supported the exchange rate of the Taka with other currencies, including the Taka/Rupee rate, and have both enabled, and have been a consequence of, macroeconomic policies which have avoided destabilizing fluctuations in the balance of payments, domestic prices and the exchange rate. As in other countries, there is no economic logic in the idea that trade should be balanced with individual trading partners, and the real concerns behind contrary arguments are usually efforts to prevent or moderate import competition.

In Bangladesh it is often argued that the deficit is aggravated by India's protectionist policies that have hobbled Bangladesh exports to India. However, for the past 8 years India's imports from the world as a whole have been growing at over 9 percent a year recently, each year's increase in imports has been exceeding Bangladesh's total exports. Many of these imports have been coming in over considerably higher tariffs than the tariffs faced by Bangladesh exporters, owing to the extensive tariff preferences given to Bangladesh by India under SAPTA, and to the extent that there are non-tariff and bureaucratic barriers, they are probably more constraining than the ones that Bangladesh would face. This suggests

² The ban on sugar imports over land border was lifted in mid-2005 while the ban on yarn imports were removed in December 2005 for 100% export industries.

that the low level and slow growth of Bangladesh's exports to India reflect fundamental comparative advantage factors, not discriminatory import policies.

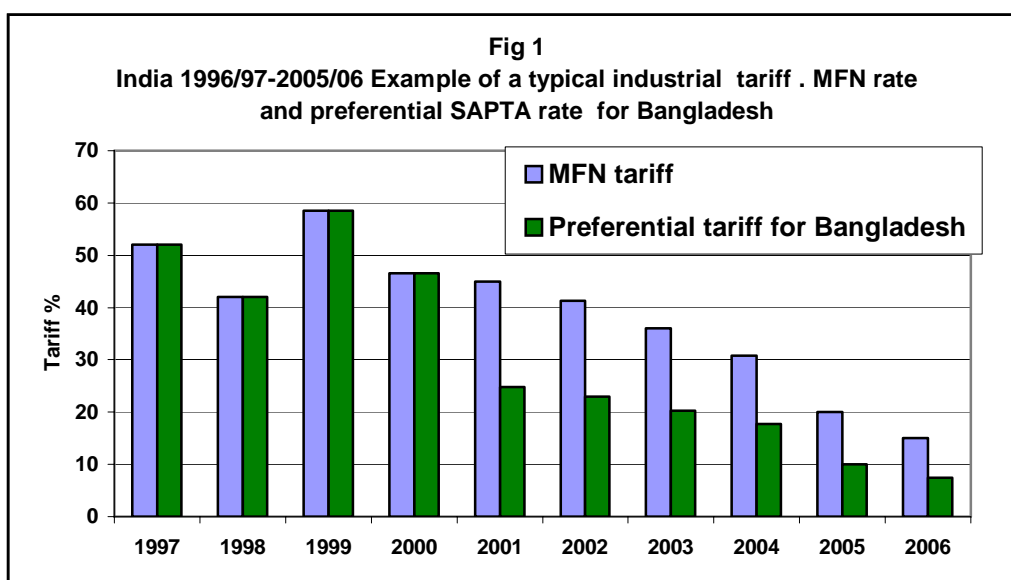
This issue is also considered in the consultant studies in the light of what is likely to happen were there free trade between India and Bangladesh. The general finding of the studies is that some aspects of India's import regime are retarding Bangladesh exports, but that in the short and medium run the potential for expanded exports to India is not very great, even under an FTA or with the full implementation of SAFTA.

India's trade policies

Non-tariff barriers. India's licensing restrictions on imports of raw materials and manufactured intermediates were removed during its 1991/92 reforms, but imports of nearly all industrial consumer goods and agricultural products continued to be restricted, either by import licensing which operated as a *de facto* import ban in most cases, or—especially in the agricultural sector—by “canalisation” through parastatals such as FCI. These restrictions were finally removed in April 2001.

Against a background of almost 40 years of *de facto* autarchy, the abolition of this comprehensive import licensing system created considerable apprehension as to how well local producers of industrial consumer goods and of agricultural products would be able to compete with imports. Partly because of this apprehension, after the Uruguay Round, India made sure that it implemented all the WTO-compatible procedures that allow non-tariff restrictions to be applied to imports.

Tariffs. As well as removing QRs from intermediates and capital goods, the 1991/92 reforms reduced tariffs and pre-announced a tariff reduction program. Under this program tariffs came down steadily from prohibitive levels at the beginning (average almost 130% in 1990/91) to much lower levels (average about 35%) in 1997/98 (Fig 1). However, in 2000, ad valorem tariffs were supplemented by the introduction of prohibitively high specific tariffs to protect textile fabric and garment producers.



Only a year after the final removal of import licensing, a new tariff reduction process started in 2002/03. This new program focussed on industrial tariffs. There were three major omissions:

- Agriculture, livestock, fisheries and processed foods (HS 01-24)
- Textile fabrics and clothing products, about half of which continue to be protected by specific tariffs
- A few important manufacturing sectors, notably the auto and fertilizer industries

For most industrial goods, there was an especially large tariff reduction in 2004/05 and 2005/06. **90 percent of industrial tariffs are now at 12.5%, far lower and far more uniform than they have ever been in the past 50 years.** From the perspective of SAARC countries including Bangladesh, these changes mean that Indian domestic markets for most manufactured goods are highly competitive, with prices that are close to world prices, and are likely to be difficult to penetrate even with complete exemption from Indian tariffs under bilateral or multilateral free trade arrangements such as those planned under SAFTA.

In contrast to industrial tariffs, tariffs on “agricultural” products (defined in the broad sense to include fisheries, livestock and livestock products, agricultural products and processed foods) were left out of the new tariff reduction program: in 2005/06, on average, they were about 40%, more than three times the level of non-agricultural tariffs

Specific duties protecting the textile and garment industries. Just before the withdrawal of import licensing from textiles and garments in April 2001, the government imposed specific duties on a large number of textile fabrics and garments, in order to protect domestic producers against low price import competition. At present these tariffs are the greater of the standard 15% rate, or the specific amount (usually Rupees per metre of per kg, or per garment). This system was designed to make it impossible or very difficult for other developing countries with strong textile and garment industries to compete in India. It also has the effect of excluding the products to which the specific duties are applied, from subsequent reductions in *ad valorem* tariffs.

Ready made garments are Bangladesh’s principal export, and these specific tariffs in India are of special concern to it in the context of regional trade arrangements including SAPTA and SAFTA. As discussed in the case study of the RMG industry, given the low margins between fabric costs and garment export prices, tariffs at this level make it very difficult for Bangladesh RMG exporters to compete in India

India’s SAPTA preferences for Bangladesh. Though SAFTA took effect from 1 January 2006, superseding SAPTA, tariff concessions offered under the latter remain valid until the completion of the Trade Liberalization Programme of SAFTA. At present India has given preferences to Bangladesh on approximately 2925 tariff lines, about 58% of the total number of its approximately 5000 6-digit HS lines. Two thirds of these preferences were agreed in the third SAPTA negotiating round and came into force during India’s 2000/01 fiscal year. A majority of the preferences are special “LDC-only” preferences: most of these are 50%, some are 60%, and a few 15%, 75% or 100%.

In practice Bangladesh is the only relevant beneficiary of India’s LDC-only SAPTA preferences, since Nepal and Bhutan have long had duty free access to the Indian market under their bilateral treaties, and the Maldives trade is negligibly small (at least from India’s perspective). Therefore, in a sense, these preferences constitute a *de facto* bilateral asymmetric preferential trade arrangement between India and Bangladesh, asymmetric because many substantial preferences have been given by India, but for all practical purposes few and negligible preferences for Indian imports have been given by Bangladesh

In order to qualify for India’s SAPTA preferences, products imported from Bangladesh would have to satisfy the SAPTA origin rule, which is that the cif value of non-SAPTA imported inputs included in the exported product should not exceed 70% of the fob price. As discussed in the case study of the ready made garment industry, this provision is extremely important for firms in Bangladesh wishing to

export woven garments to India, because value-added margins in cutting, sewing and assembling garments from imported fabrics are typically around 30% of fob prices, and may be less. To get around this constraint, they can use imported Indian fabrics, even though they might not have done so if they had a free choice unconstrained by this consideration.

Anti-dumping (AD) is one of the WTO-legitimate measures that India introduced during the 1990s, as a way of providing extra protection as its tariffs came down and its import licensing system was dismantled. By the late 1990s and early 2000s, India had become the world's most active user of anti-dumping. However, there are recent indications that AD activity has been slowing: the number of new cases brought during 2003/04 was 14 compared to 30 in each of the previous two years

So far, there have only been three cases involving SAARC countries, two in Nepal, and one in Bangladesh. The Bangladesh case was finalized in December 2001, and involved Indian imports of lead acid vehicle batteries from Japan, Korea, China and Bangladesh. Anti-dumping duties were imposed on all imports from the four countries, and in the case of the Bangladesh firm these were prohibitive and blocked all subsequent exports to India.

As regards Bangladesh's trade with India, the large number of Indian AD cases against exporters in China and other countries, and (except for the acid battery case) the absence of AD actions against Bangladesh exporters, is an advantage for Bangladesh exporters by sheltering them to some extent from the competition of these other exporters. However, most probably this situation principally reflects the absence of Bangladesh exports. Were they to expand, even if their shares in the Indian markets of individual products were small, the exporting firms face the risk that they will be caught up in Indian AD actions mainly concerned about imports from other countries, as happened in the acid battery case. The best strategy for reducing the likelihood that AD cases will be brought, and for minimising the damage if they are, is to follow low protection policies in the domestic market. By following its present protection policies with the almost automatic use of para-tariffs to provide very high protection levels (see below) Bangladesh is doing the opposite and increasing its vulnerability to AD actions in India and elsewhere, if these protected industries begin to export.

Export policies India operates a comprehensive set of export policies. Three aspects of these policies that are relevant for India's trading relationship with Bangladesh in the context of a bilateral FTA or SAFTA are described below:

- India restricts the Customs posts which can administer its various import duty neutralisation schemes, and in June 2005 it was reported that DEPB³-which is one of the most widely used-was not available at any of the land border Customs posts with Bangladesh except at Petrapole.
- Rebates for exporters under these schemes have been substantially reduced during the past five years as tariff levels have declined. These reduced rates mean that Indian domestic prices of exportable garments (as well as of other exportables) are likely to be not far above fob export prices, and may be below cif prices, increasing the difficulty for Bangladesh exporters to compete in the Indian market, even under an FTA.
- In recent years India has demonstrated that it is willing to subsidize its exports of rice when there have been large domestic surpluses. In some years India's exports were large relative to the narrow international market and probably reduced world prices, with resulting economic welfare benefits to Bangladesh as an importer.

³ Duty Exemption Pass Book. This system is described in the *Overview* report and in recent changes in DEPB rates for garments are given in the RMG industry case study (Table 6, p.15).

Bangladesh's trade policies

This section summarises some of the main findings of the World Bank's trade policy *Overview* report that are relevant for the Bangladesh's trading relationship with India, and includes new information that is now available for 2004/05, especially on Bangladesh's para-tariffs, which during 2004/05 continued to increase their role in Bangladesh's policies of protecting domestic producers from import competition.

Non tariff barriers. During the late 1980s and early 1990s, import licensing system was abolished. Of the continuing QR restrictions the most important were the parastatal import monopoly over sugar and the ban on textile fabric imports for use in the domestic market, which protected the textile industry. The sugar import monopoly was removed in September 2003 and the import ban on textile fabrics in January 2005, both being replaced by very high tariffs. But there are still QRs on the import of chicks, eggs, salt,. Various permits, clearances and approvals are also required for extensive lists of other products, even though they are not formally subject to import licensing. In the various studies undertaken as part of this project, except for sugar and textile fabrics, explicit QRs did not emerge as an impediment or special issue either for Indian exporters or in Bangladesh, possibly because the products still subject to QRs were not covered in the studies..

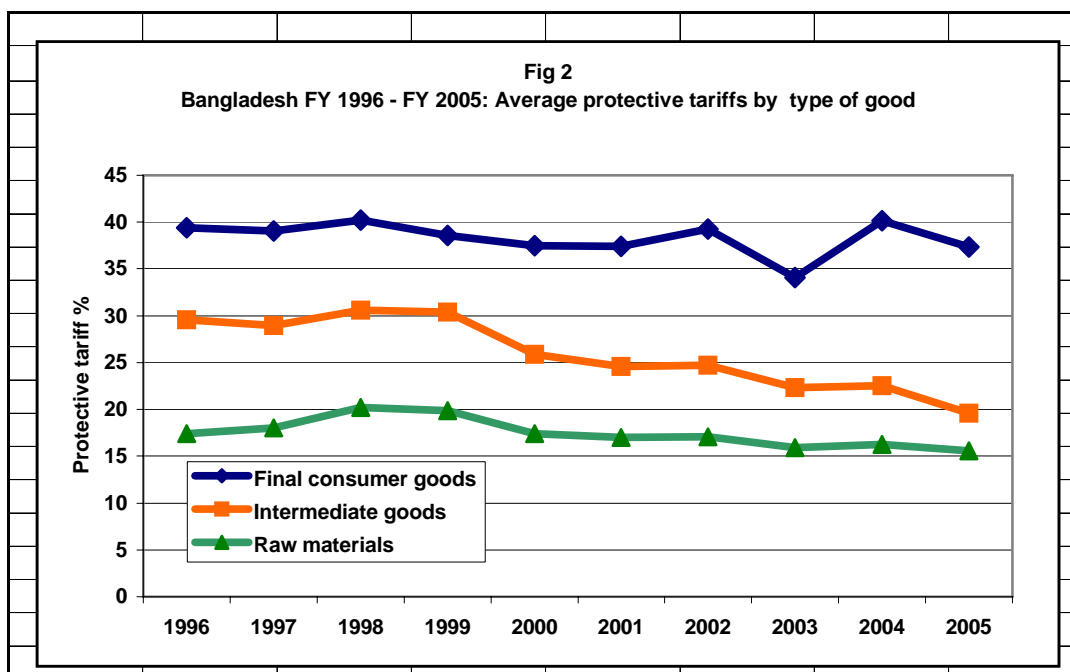
Customs clearance at land border Customs posts The land border trade is subject to very serious administrative constraints in Bangladesh, because 38 out of the 42 land border Customs posts with India severely restrict the imported goods that can be cleared, and only four land border posts can clear all imported goods. In terms of volume the most important by far of the Customs posts with comprehensive Customs clearance powers is at Benapole, which borders Petrapole on the Indian side and which is on main roads linking Kolkata with Jessore and Dhaka.

In addition to these general constraints on imports by the land border, both Bangladesh and India have periodically constrained imports of certain products by specifying the ports at which they can be cleared by Customs. This in turn provides a strong incentive to send the goods illegally, either by "bootleg" smuggling which bypasses the Customs posts altogether, or by "official" smuggling involving bribes to Customs and other officials on both sides of the border

General tariff trends. The drastic tariff reductions of the early 1990s stalled after 1995/96, and during the following ten years up to 2004/05, tariffs declined only slightly. Average industrial tariffs came down modestly but the average protective rate for agriculture (including fisheries, livestock and processed foods) was 32.7% in 2004/05, slightly higher than it had been 10 years earlier. By July 2006, the unweighted average protective rate over all tariff lines declined by 7.7 percentage points, from 32% to 24.3%.

Para-tariffs This slowing of tariff reduction occurred because continuing cuts in Customs duties were offset by increases in the scope and levels of a variety of para-tariffs which were imposed on top of Customs duties. By 2004/05 about 40% of the unweighted average protection level was due to para-tariffs, and para-tariffs were being applied to 21% of total tariff lines.

The para-tariffs have been principally but not exclusively used to provide extra protection to domestically produced consumer goods. As a result, during the 10 years since 1995/96 there has been no downward trend in the average protection rate of consumer goods (Fig 2) despite reductions in Customs duty rates during the period and the discontinuance of the license fee in 2002/03. By contrast the average protection rates on basic raw materials, intermediate goods and capital goods are much lower, and in the case of raw materials and intermediate goods have been trending down since 1998/99.



“End user” tariff concessions. As well as using the para-tariffs to raise the protection for the outputs of domestic industries, the government has developed a system of special “end user” tariffs which provide low concessional tariffs on the inputs and capital equipment for specified industries or for specified uses. These concessional tariffs are much lower than normal MFN tariffs, and in the case of machinery and parts used by exporters, the concessional tariff is zero. However, there are only two major industries which receive special end-user concessions for their intermediate materials, namely the pharmaceutical industry and the insecticide industry. Bangladesh has well developed systems (mainly export processing zones and bonded warehouses) for providing duty free intermediate materials for its export firms, and this is not handled as part of the “end user” concessional tariff system..

Agriculture, livestock, fisheries and processed food. Bangladesh’s trade policies in these sectors warrant separate treatment because, as in India, they differ in important ways from its manufacturing trade policies, in addition to which Indian agricultural products are generally a large although fluctuating share of its total exports to Bangladesh.

The high protection rates for some of the agricultural and other primary products, but especially of processed foods, from the viewpoint of Bangladesh consumers constitute a substantial and highly regressive indirect tax. This has important implications for the likely economic effects of an FTA with India, because if Bangladesh were to import these products duty free there could be large economic welfare benefits for Bangladesh consumers, but also difficult adjustment problems for the Bangladesh producers that lose protection. How the resulting economic costs and benefits might work out is discussed in a project case study paper using the example of the sugar industry. By contrast, it is probable that not much would change for Bangladesh consumers or for producers, if rice and Bangladesh’s other cereal crops were included in an India-Bangladesh FTA, because of the Bangladesh protection levels that are already quite low.

Bangladesh’s tariff preferences for India. Bangladesh gives tariff preferences to imports from India under the Bangkok Agreement and under SAPTA. Overall, the tariff preferences Bangladesh has given to India (and to the other member countries) under both the Bangkok Agreement and SAPTA are

purely symbolic: their main effect has been to further increase the complexity of the tariff schedule and Customs administration rather than to provide any substantive preferences for imports from India of any of the other Bangkok Agreement or SAPTA countries.

Export policies Bangladesh's exports are dominated by ready made garments, most of which are exported to the US and the EU. Nearly all garment exports are from firms operating in export processing zones or as bonded warehouses. In both cases they can import their textile and other inputs free of Customs duties and all other import taxes (including the 3% advance income tax) with the use of "back-to-back LCs" i.e. letters of credit based on LCs issued for their exports. As noted previously, machinery used by exporters is also exempt from all import taxes under the "capital machinery" provision for exporters. There is also a 5% subsidy on domestic fabrics used by garment exporters. Apart from these, there is a standard array of duty neutralization schemes (e.g. duty drawback) and export incentives (e.g. preferential export credit) and export promotion institutions and activities of the kind used in many developing countries (see the trade policy *Overview* report for a summary). In addition, however, there are a number of non-standard export policies which would need to be discussed with India in the context of bilateral FTA, or with the India and the other South Asian countries in the context of SAFTA. These combine export bans and restrictions on a number of unprocessed or partially processed primary products and export subsidies when some of these products are exported in processed form. The intention of these measures is to make processed exports more profitable by increasing gross margins by lowering the prices of the raw materials and increasing the return from the exported finished products, but both measures contravene WTO rules and the Agreement on Agriculture in particular. They are also likely to run into trouble if used to promote exports to India or to one of the other South Asian countries as part of a free trade agreement.

Reconciling the trade statistics

A component of this study is a paper which provides detailed comparisons of the Indian and Bangladesh statistics of bilateral trade. One purpose of this exercise was to check whether there were any major discrepancies as to the general level of, and trends in, the total recorded trade. Secondly, by making detailed comparisons, the object was to throw some light on the scale and scope of overinvoicing, underinvoicing, and similar practices, the likely products involved, and more broadly the potential scale of "technical smuggling".

In making these comparisons it turned out that the Bangladesh NBR trade database does not record "back to back L/C" imports i.e. imports of duty free intermediate inputs used by Bangladesh EPZ and bonded warehouse exporters, and so these are recorded in the Indian export statistics but omitted altogether from the corresponding Bangladesh NBR import statistics.

Fortunately payments under back-to-back LCs are recorded by Bangladesh Bank, adding the totals to NBR's total import data, gives a very approximate correspondence between the general level of the two sets of data for the years 1998/99 to 2002/03. Both statistics also indicate similar year to year changes during this period. Although data recording deficiencies and statistical errors may conceivably explain some of these differences, they are consistent with many reports of illegal practices at the Bangladesh Customs, especially at the Petrapole-Benapole land crossing, and with large scale discrepancies between the Indian and Bangladesh trade statistics data at product level.

As regards the much smaller reverse trade from Bangladesh to India, the correspondence between Bangladesh's aggregate export statistics and the Indian import statistics is fairly close. Over the whole period, the difference between aggregate Indian imports and aggregate Bangladesh exports has the expected positive sign, and the positive margins correspond to the expectation that cost of freight and insurance is low. This does not mean there was no undervaluation or misclassification to avoid import

duties occurring on the Indian side, only that it was not so egregious as to show up in the aggregate import statistics.

As well as comparing aggregates, the consultant study also compared the Indian export and Bangladesh import statistics for 1999/2000 and 2000/01 at HS 6-digit product level. The value differences were quite minor for most of the individual products analyzed. However, when the study looked at a sample of products that had high values in either the Indian export statistics or the Bangladesh import statistics, large discrepancies were discovered, predominantly cases with lower values in the Bangladesh import statistics than in the Indian export statistics, but also the reverse i.e. where the recorded import values in Bangladesh considerably exceed the export values in India.

In addition to income tax evasion, some researchers in Bangladesh have suggested that over-invoicing--especially of capital equipment imports-- is used to accumulate unrecorded foreign exchange outside the country, which in turn finances illegal imports or is used to profit from free market premia on the official exchange rate. Tax evasion and the various advantages of holding black money outside Bangladesh could still be relevant motivations and may explain some of these observed differences between the Indian and Bangladesh statistics.

Bangladesh imports from India: composition, trends and potential under an FTA

Disaggregating the Bangladesh import statistics by some major commodity categories shows the following:

- Highly variable but sometimes large imports of cereals (mainly wheat and rice) from India. Bangladesh is also importing from other countries, but India has been the main supplier in recent years.
- An apparently declining role of India as a supplier of duty free intermediate goods (mainly textiles) for Bangladesh's export RMG sector.
- According to Bangladesh's import statistics, India is supplying fairly constant shares of Bangladesh's imports of basic raw materials, intermediate goods used for domestic production, capital goods and non-cereal final consumer goods. However, according to India's export statistics, exports of these products have been growing considerably faster than indicated by the Bangladesh import statistics, on average at around 15% annually since 1996/97, with especially big increases in 2002/03 and 2003/04.

India exports a wide range of products to Bangladesh. According to the Indian export statistics for 2003/04, there were at least some exports in all but 4 of the 98 HS chapters. About a third of total exports were primary agricultural, fish and livestock products, 6.6% processed foods and drinks (including animal foods), and most of the rest manufactured products. Leaving aside textile and clothing exports, most of which go duty free to Bangladesh RMG exporters, India was supplying 21.5% of Bangladesh's total recorded imports for use in the domestic market. Adding unrecorded smuggled imports, the Indian share of total imports for the Bangladesh domestic market is plausibly between 30% and 35%.

This means that Indian exporters to Bangladesh are successfully competing with exporters in the rest of the world (ROW) and have achieved substantial shares in Bangladesh's import markets, while in most cases paying relatively high tariffs which in principle are the same for all exporters. If Bangladesh's MFN tariffs for the rest of the world were to remain the same while India received duty free treatment under SAFTA or a bilateral FTA, for most of these products Indian exporters would have a substantial price advantage in products in which it appears from the trade data they are already highly competitive.

An NCAER survey asked Indian traders who were already exporting to Bangladesh by what percentage they would expect their exports to expand under three different hypotheses on Bangladesh

tariff reductions (50%, 75% and 100%). For the free trade alternative (100% tariff reduction) the average estimated increase for 58 products was 34 %, distributed as follows: agricultural products 31%, processed foods 45%, manufactures 35%.

These responses underline the considerable potential for trade diversion with an FTA i.e. the probability that Indian exporters would be able to undercut ROW suppliers and substantially increase their shares in Bangladesh's import markets. On the basis of 2003/04 trade data, before allowing for market share increases, a very rough estimate of the Bangladesh government import duty revenue loss is \$207 million. It would be greater than this to the extent that Indian exporters increase their import market shares

Bangladesh exports to India: composition, trends and prospects under an FTA

Since 2001/02 Bangladesh's officially recorded exports to India have been increasing fairly rapidly, and this increase was sustained until fiscal year 2005/06 when it rose to around \$200 million. However, it was from a very low level of only \$50-60 million in 2001/02. It is still a miniscule share of India's total imports (less than 0.1%) and only about 1% of Bangladesh's total exports. About two thirds of Bangladesh's exports to India consist of just two products, anhydrous ammonia (which is imported duty free as an input into India's urea industry) and raw jute. According to the various informal trade surveys, smuggled merchandise exports from Bangladesh to India by the bootleg route are also very low.

The very low level and slow growth of Bangladesh's exports to India is not necessarily attributable to restrictive import policies in India.

- For industrial products without SAPTA preferences, Indian industrial MFN tariffs came down from 44.9% in 2000/01 to 30.8% in 2003/04, to 20% in 2004/05, and to 12.5% in 2006/07. Despite this steep decline only 7 Bangladesh industrial products without SAPTA preferences appear in India's 2003/04 import basket, and then at very low annual import levels of no more than about \$300,000 per product.
- Most of India's 2925 (HS 6-digit) SAPTA preferences for Bangladesh are on industrial products, and the most frequent concession rate is 50%. Assuming this preference rate, a typical Indian industrial preferential tariff for Bangladesh has declined during the past five years from 23% to 7.5%. Despite this, only seven industrial products with preferences appear among India's principal imports from Bangladesh in 2003/04, and the imports of each of these were less than \$500,000. This almost complete absence of response of Bangladesh exports to the numerous and fairly substantial Indian preferences under SAPTA, and to the decline of the preferential tariffs over the period, suggests that currently Bangladesh producers are probably not producing many products that are in demand in India. Alternatively, if these products are being produced in Bangladesh, it seems that, despite declining Indian tariffs, Bangladesh producers' costs are too high to compete with Indian producers, or with exporters in other countries who have to pay the higher MFN tariffs.
- Three quarters of Bangladesh's exports are ready made garments, most of which go to the US and Europe. Bangladesh RMG producers appear to have a marked labour cost advantage over RMG producers in India, owing to lower wages and similar labour productivity, but India's specific duties on garments appear to have prevented any substantial penetration of its domestic markets by developing country clothing producers including Bangladesh. Under SAPTA, Bangladesh RMGs benefit from Indian preferences –mainly either 50% or 60%-and these are applied to reduce both the *ad valorem* and the specific components of compound tariffs. Presumably helped by this protection and the SAPTA preference advantage, Bangladesh RMG exports to India-almost entirely woven cotton shirts -grew fairly rapidly after 1999/2000 up to 2003/04, but the total level in that year (\$4.57 million) was still tiny both in relation to the Indian

domestic RMG market and to Bangladesh's total RMG exports. This suggests that high protection levels provided by India's specific duties on garments are mostly redundant by wide margins. That is, actual domestic prices in India are probably not far above and may even be below prevailing international prices at the cif stage in India. It is also relevant that Sri Lanka- which is a major RMG exporter- has had negligible RMG exports to India, despite the 75% preference for garments negotiated under the Sri Lanka-India FTA.

In general, India's import policies for "agricultural" products have been and remain much more protective than its industrial protection policies, and in their present form they preclude substantial Indian imports from Bangladesh or from any other country. .

How about the prospects for Bangladesh exports to India under an FTA or under SAFTA in which Bangladesh exporters would have duty free access to the Indian market would not be subject to Indian NTBs (such as its agricultural import monopolies), while India's existing tariffs and import policies would remain in place with respect to the rest of the world? Based on the performance of Bangladesh's existing industries, the short to medium run prospects for expanded exports to India even in such favourable circumstances appear to be quite modest. The most obvious apparent opportunity would appear to be in RMGs, but:

- India is also a major exporter of RMGs, in 2003/04 with exports of \$6.2 billion versus Bangladesh's exports of \$4.9 billion. Indian domestic prices of exportable garments appear to be close to or even below cif prices.
- These likely difficulties of competing in India are compounded by the absence of a competitive low cost textile industry in Bangladesh, more so for fabrics than for yarns. This means that RMG firms exporting to India would have to deal with the usual delays and difficulties of international procurement of their textile inputs, whereas the Indian firms with which they would be competing would in general obtain their inputs at highly competitive prices nearby in the domestic Indian market.
- In order to satisfy whatever rules of origin would be agreed under the FTA, Bangladesh exporters would probably need to source some of their textile inputs in India. If that turns out to be the case, it would be crucial to ensure fast and low cost transport and Customs clearance of the textile inputs obtained from India, preferably over the land border. Otherwise, if costs are high and there are unpredictable delays, Indian traders will be deterred from ordering garments in Bangladesh rather than in India.
- If the Indian RMG market were to be opened preferentially to Bangladesh exporters on a free trade basis, and Bangladesh exporters were able to take advantage of the opportunity, it is likely that some of the RMG exports that go to India will be diverted from other markets. Hence, not all of the increase in RMG to India would represent a net increase in total Bangladesh RMG exports.
- The RMG market in India is far larger and more diversified than RMG production in Bangladesh. Even so, because of the importance of product differentiation in final consumer goods like garments-style, fashion, brands etc-some Bangladesh producers might be able to find market niches in India if they are able link into strong Indian marketing organizations. However the reverse is also the case, and under an FTA with India, RMG exports from India to Bangladesh based on these considerations could be substantial.

The report also considers the export prospects in India under an FTA of Bangladesh's principal secondary exports and also finds that that the prospects for exporting these products to India under an FTA appear to be quite limited. This is because (1) the Indian tariffs on the products that are currently being exported to India in non-negligible quantities-fertilizers and raw jute- are zero and 2.5%, so an FTA would make little difference; (2) exports of the other products to India are zero or negligible despite low Indian preferential tariffs in most cases; (3) with some exceptions, exports would have to compete in

India with Indian firms that are exporting themselves and are likely to be highly competitive in their domestic markets.

These apparently very limited possibilities for Bangladesh to find substantial export markets in India under an FTA for its present major exportables, suggest the best prospects may be in industries and products which are still to be developed, for example natural gas itself or products such as power, fertilizers, chemicals, steel etc based on natural gas or coal inputs and/or other resources. This kind of development could be accelerated and distribution and marketing in India facilitated by direct investment including joint ventures on the part of Indian firms.

Informal and illegal trade: dimensions, trends, composition, and the role of domestic indirect taxes

Ever since Bangladesh's independence there has been a substantial informal unrecorded trade across the India-Bangladesh land borders. Much of this trade is quasi legal and is best characterized as "informal" rather than illegal, because there is wide participation by local people in the border areas, and the trade generally bypasses Customs posts. At the other extreme there is trade which goes in larger quantities-mostly by truck-through the formal legal Customs and other channels, but which involves explicitly illegal practices such as underinvoicing, misclassification and bribery of Customs and other officials, and which in Bangladesh is sometimes called "technical" smuggling.

All the literature on the India-Bangladesh informal trade confirms that this trade is essentially one-way, from India to Bangladesh. Leaving aside gold, silver and currency which is smuggled into India in part to pay for Indian goods, smuggled "bootleg" merchandise exports from Bangladesh exports to India have been estimated at only about 3% of smuggled bootleg Indian exports to Bangladesh. There are no studies of "technical" smuggling from Bangladesh to India, but the scale is probably small in view of the very low level of the recorded trade.

According to very approximate estimates based on surveys in Bangladesh during 2002, total smuggled exports ("bootleg" plus "technical") from India to Bangladesh may have been around \$500 million, about 42% of Bangladesh's recorded imports from India in 2002/03, or about 30% of total imports (recorded plus smuggled). Most of the smuggled imports came by the land border, and the total estimated value of "technical" smuggling was slightly higher than the value of "bootleg" smuggling. However, this estimate is based on interviews with "knowledgeable persons" in various regions on the Bangladesh side of the border only, and the estimated values of smuggling in some key products (notably cattle and sugar) are much lower than estimates from the Indian side. These discrepancies suggest that the total smuggling could be as high as \$900 million, equivalent to about three quarters of the total recorded trade, or about 42% of total Bangladesh imports (recorded plus smuggled).

Comparisons of three studies of "bootleg" smuggling suggest that it may have declined over the 8 years, 1995-2003, and it might be tempting to conclude from these statistics that smuggling from India has been declining and to link the apparent decline to import liberalization in Bangladesh, in particular to the steady reduction of Customs duties during the same period. However, for a number of reasons this would be a hazardous generalization because of inherent deficiencies in the surveys and the fact that there were no attempts to study "technical" smuggling prior to 2002. In addition some trends in Bangladesh's import policies since 1998/99 have probably increased rather than reduced smuggling incentives, in particular the use of para-tariffs which have drastically increased protection rates on a wide range of locally produced consumer goods. The increasing bifurcation of protection rates, with very high tariffs (including para-tariffs) on locally produced consumer goods and low tariffs on raw materials and intermediates, has also increased the incentive and potential for "technical" smuggling through false documentation, i.e. falsifying the description of products so that they are misclassified as products subject to low rather than high tariffs.

The consultant studies find that preferences for formal trade will be influenced by:

- The level of Bangladesh protective tariffs.
- The rigor of Customs administration, especially on the Bangladesh side.
- The nature of the goods and VAT administration in Bangladesh.
- The state of the infrastructure (roads, storage, technical and administrative capabilities etc) on both the Indian side and the Bangladesh side at the border Customs posts, and the resulting time and transaction costs associated with the use of these formal routes.

The report suggests a number of policy and other reforms that would serve the economic interests of both India and Bangladesh by channelling trade away from the bootleg routes to the formal routes, and by reducing the incentives and scope for corrupt practices in the formal routes:

- Bangladesh would bring down its presently very high tariffs protecting import substitution industries by reversing the policies under which protection rates have been drastically increased over the past 6 or 7 years by the use of para-tariffs on top of Customs duties
- Both countries would improve the infrastructure –physical and administrative-at their land border Customs posts. This would need to be done in a coordinated way-there would no point if the infrastructure were improved on one side of the border but bottlenecks were to remain or even increase on the other side of the border.
- Both countries would continue and accelerate efforts to streamline and improve the administrative structures that affect land border trade, especially Customs administration. For Customs the purposes would be to speed up and simplify Customs clearance and to reduce the incentives for, and scope of corrupt practices.
- The administrative reforms would include expanding the facilities and the Customs clearance powers available at Bangladesh’s smaller land border Customs posts.

Trade financing, logistics and transaction costs

A study of the financing of India-Bangladesh trade points out that the hawala networks perform better than the formal banking system in terms of simplicity, speed, transaction costs, and reliability, and that for these reasons they are not only financing much of the informal bootleg smuggling trade from India to Bangladesh, but also substantial parts of the exports to Bangladesh that go through the legal routes. It notes that under Bangladesh Bank rules LCs are compulsory for all import consignments in excess of \$5000, but involve very high transaction costs, mainly due to credibility problems of Bangladesh banks and resulting high confirmation charges by prime US or other international banks. As a result, according to the study, in practice “the LC is a mere cover to move goods through the Customs”. This finding, that the LCs in this trade are not in practice being used for their normal function of reducing the risks and facilitating financing for both the importers and the exporters, implies that they would not be used in the trade if they were not compulsory. If this is correct, they involve non-negligible transaction costs without protecting the suppliers and importers against commercial risks such as defective shipments, non-payment, delayed payments etc

Informal exports from India to Bangladesh are also paid for by gold and Taka smuggled into India. The smuggled Taka are used to buy Rupees from informal foreign exchange traders who offer considerably more favourable Taka/Rupee rates than can be obtained from the banks, which are obliged to first convert the taka to US dollars and then to Rupees, as there is no official direct Taka/Rupee foreign exchange market. The study states that the lack of such an official market means that remittances to Bangladesh of the Bangladeshi immigrant community in India, go entirely by the informal hawala networks, and argues for the establishment of an official Taka/Rupee market to facilitate these remittances and also India-Bangladesh trade.

There are serious logistical problems (congestion, delays, side-payments etc) at the land Customs stations on the India- Bangladesh border. NCAER organized surveys of exporters and transporters in the Kolkata-Petrapole region which handles by far the largest share of the recorded India-Bangladesh land border trade through Benapole in Bangladesh. The NCAER survey at Petrapole did not systematically investigate the logistics costs of Bangladesh exports to India, but, according to the authors, Bangladesh exporters are treated in an unsympathetic and discriminatory way at Petrapole. This is of considerable interest and concern in Bangladesh and would be worth exploring in follow-up studies..

There is strong case for investing in larger and much improved infrastructure and facilities at Petrapole and at the other land border Customs stations. For Bangladesh the present system involves substantial terms of trade losses, since the landed costs of imports from India of products such as wheat, rice, fruit, cattle feed, bauxite and other products appear to be much higher than they would be if the congestion were removed. Bangladesh exporters and potential exporters also have an obvious interest in faster and less expensive commodity movements across the border. Likewise, on the Indian side, even though it can be assumed that the congestion costs of exports to Bangladesh are recovered in the prices charged, at higher prices the volumes of the exports must be lower than they otherwise would be. If the required investments are not made, congestion will increase with the general growth of trade, and would largely cancel or offset economic benefits that would otherwise occur if tariffs or other trade barriers were to be reduced. This last point is especially relevant if India and Bangladesh were to ever implement an effective FTA, since without very substantial investments in infrastructure and administrative capabilities, increases in trade would be slowed down or blocked by increases in congestion and the associated increases in “speed money” rents.

Quantifying the economic costs and benefits of an FTA: some industry case studies

If there were a bilateral free trade agreement between India and Bangladesh, or if SAFTA is eventually implemented in a comprehensive way, there would be economic costs and benefits for various groups in the two countries and for the two governments, and also repercussions affecting exporters and importers outside the South Asia region. In order to bring out these issues in a reasonably non-technical way, a methodology was developed for analysis at the level of individual industries, and applied in a number of industry case studies.

In this methodology, changes in “economic welfare” resulting from an FTA are treated as the sum of changes in the money value of consumers’ surplus, producers’ surplus and government revenue from tariffs (customs duties). Consumers’ and producers’ surpluses are a shorthand way of summarizing economic benefits that may accrue to a variety of economic agents, not just final consumers and producers. For example, governments normally share in producer surpluses through taxes on profits, and some shares may go to foreigners if there is portfolio and/or foreign direct investment (FDI). It is also likely that traders (e.g. wholesale distributors and exporters) may share in producer surpluses, especially exporters who undertake marketing functions.

Free trade agreements discriminate against imports from rest of the world (ROW) countries that are not parties to the agreements. Insofar as the imports from the ROW countries that are excluded are traded at lower prices than the imports from the FTA countries, there is an economic welfare loss for the FTA members, and also an economic loss for the ROW exporters who lose their markets. These trade diversion effects need to be allowed for in any comprehensive evaluation of the costs and benefits of FTAs. The difficulty of quantifying these effects does not diminish their importance, and as a rule of thumb it might be plausible to assume that the per unit producer surplus losses resulting from the excluded ROW exports at least equal the producer surplus gains of the new exports from the FTA member that replaces them. This kind of calculation is discussed in the cement industry case study, where

it appears that an India-Bangladesh FTA would exclude Indonesian, Malaysian and Thai clinker exporters from the Bangladesh market.

Case studies simulated the likely effects of an India-Bangladesh FTA in the following industries:

- Cement
- Light bulbs
- Bicycle rickshaw tyres
- Sugar
- Ready made garments

In the simulations for the first four of these industries, it turned out that under an FTA there are expanded Indian exports to Bangladesh, but no exports from Bangladesh to India. This was not predicted in advance, but was a result of finding that in the 2002/03 base scenario (a) India was exporting all these products to the rest of the world and –except for cement–also to Bangladesh (b) Indian export prices were substantially lower than ex-factory before-tax prices of the same or similar products in Bangladesh (c) none of the products were being exported from Bangladesh (d) potential export supply prices in Bangladesh–defined as ex-factory prices minus estimated duty drawback for inputs subject to tariffs–in each case substantially exceeded ex-factory prices in India.

The simulations for ready made garments (using the example of mens’ cotton shirts and trousers) predict increased Bangladesh exports to India, but also increased RMG exports from India to Bangladesh.

In the base simulations for cement, light bulbs, rickshaw tyres and sugar, following an FTA production in Bangladesh ceases altogether and the entire Bangladesh market is supplied by imports from India. In each of these industries, this seemed to be the most plausible likely outcome *given* the information obtained on prevailing prices and costs in Bangladesh, even after allowing for cost reductions that would result from duty free imports of intermediate inputs from India that would also result from an FTA. It was not a surprising outcome in view of the very high protection rates all of these industries were receiving in Bangladesh, and the fact that –despite apparently substantial smuggling of a number of these products–actual domestic prices were approximately reflecting the tariff protection that had been provided. The protective tariff rates (Customs duties plus para-tariffs) in 2002/03 were:

Table 1: Protection rates on selected goods traded

Cement	66.7%
Light bulbs	66.0%
Bicycle rickshaw tyres	35.5%
Sugar	86.4%
Ready made garments (cotton shirts & trousers)	65.5%

In the simulations for the first four of these industries, the duty free imports from India create economic welfare benefits for Bangladesh consumers which considerably exceed the economic welfare losses of Bangladesh producers plus the government fiscal losses which are a result of the zero tariffs on the imports from India. Hence, in each case, the FTA creates a substantial net welfare benefit for Bangladesh. Because of the very high Bangladesh tariffs and the resulting large gaps between the protected prices pre-FTA and India’s export prices, these “welfare triangles” are much larger than the welfare triangles often found in similar exercises in other countries

Since Indian exports expand there are also economic benefits for the Indian producers (producer surpluses), so in each of these cases the net joint economic benefit to Bangladesh and India together exceeds the net economic benefits in Bangladesh alone. On the other hand the FTA diverts trade from the

countries that were previously supplying Bangladesh with imports of the finished products or with inputs for the Bangladesh industries that cease production following the FTA.

With the exception of the RMG case study, the economic welfare outcomes depend crucially on what is assumed about competition between Indian exporters to Bangladesh following an FTA. The base scenarios assume that the Indian industries are competitive and following an FTA would export to Bangladesh at the export prices they were charging prior to the FTA in selling to the rest of the world and to Bangladesh. But in signing on to an FTA with India, Bangladesh in effect would be extending its general tariff protection levels to Indian as well as to Bangladesh producers, and this raises the possibility for the Indian firms to collude and sell to Bangladesh at higher prices than their prevailing export prices to the rest of the world, and even at higher prices than their prevailing domestic prices. If that happens, as discussed in some of the case studies, the Indian industry extracts a share of the consumer welfare benefit that would have gone to Bangladesh consumers in a competitive scenario.

The RMG industry case study was chosen to explore the possibility of Bangladesh exports to India following an FTA and the economic welfare consequences. As expected, lower wages in Bangladesh than in India combined with similar labour productivity mean that RMG production costs in Bangladesh are lower than they are in India. Moreover, some Bangladesh exports to India of mens' and boys' woven shirts started in the late 1990s and were growing fairly rapidly up to 2003/04, although starting from a very low level. Since these exports were taking place over fairly high Indian tariffs (28.4% for shirts in 2003/04) it seemed plausible that exports would increase at a faster rate under an FTA, and the economic welfare consequences were estimated for alternative annual export levels to India of between \$8.5 million and \$41 million. The paper argues that higher export levels for Bangladesh shirts than these are unlikely because of evidence that the Indian domestic market for RMGs is highly competitive, with domestic prices not far above fob export prices. It also argues that some part of increased Bangladesh exports to India would be diverted from exports to other countries, so that the net export increase from the opening to the Indian market provided by the FTA would be less than the increased exports going to India.

Implications for Bangladesh and Indian trade policies

Implications for Bangladesh. The simulated economic effects of an India-Bangladesh FTA in the industry case studies which predict Indian exports to Bangladesh, all indicate large economic welfare gains for Bangladesh consumers which far outweigh the total of government revenue losses, producer surplus losses resulting from the contraction of Bangladesh production, and losses of economic rents in Bangladesh resulting from the contraction of both “bootleg” and “technical” smuggling. In addition, an FTA would also generate some Bangladesh producer surplus gains from expanded exports to India, but these are likely to be quite limited owing to the highly competitive nature of most Indian markets. All this presupposes that infrastructure and administrative capacity would have to be greatly improved and expanded on both sides of the land border crossings to reduce bottlenecks and to stay ahead of the expanded bilateral trade, otherwise the economic welfare gains from the FTA would be severely compromised by increasing congestion, delays and informal payments.

The prediction that an FTA with India could bring large net economic welfare benefits for Bangladesh must be qualified by some important risks:

- By providing a captive protected market to Indian suppliers, there is a risk that instead of exporting to Bangladesh at prevailing world prices, the Indian producers will collude with each other and possibly with some Bangladesh producers and set prices that will transfer most of the economic benefit of the FTA arrangement to India. This could result in a net economic welfare loss for Bangladesh.

- There is a risk of terms of trade losses for Bangladesh if, following the FTA, some Indian industries export to Bangladesh at competitive prices which are nevertheless higher than prevailing world prices. As it happened, none of the few industries chosen for study in the project fitted this pattern, but it is highly likely that would be some among the large numbers of products being produced in India but not currently being exported. The terms of trade loss for Bangladesh in such cases is the excess of these Indian export prices over cif import prices when the same products are imported from the rest of the world.
- In the recent past India has subsidized its exports of rice, wheat and sugar in order to get rid of excess stocks generated by problems with its domestic support and other policies. Bangladesh has benefited from these subsidies by importing Indian supplies of these commodities at the subsidized prices. However, if Bangladesh were a captive market for these products under an FTA, India would be able to supply Bangladesh at whatever higher prices would be possible given the Bangladesh MFN tariffs, probably involving lower or zero Indian export subsidies.

These risks for Bangladesh of an India-Bangladesh FTA are substantial and serious, and raise the basic question: why not aim to obtain the same economic welfare gains from a policy of multilateral import liberalization, which could produce the same consumer surplus benefits for Bangladesh consumers and the same net domestic economic benefits, while avoiding the risks?

Implications for India India's trade with Bangladesh is very small relative to its total trade and to its economy, and so the economic welfare consequences of an FTA involving Bangladesh (whether bilateral or as part of SAFTA) are also quite minor even though they are significant for Bangladesh. As discussed above, there are potential producer surplus benefits for Indian producers and traders from the expansion of exports to Bangladesh that would result from an FTA.

The RMG case study suggests the possibility of some Indian consumer welfare benefits from Bangladesh RMG exports to India under an FTA, but these and other potential consumer welfare benefits appear to be quite limited in view of the current general openness of India's industrial import policies, and the competitiveness of domestic production and prices in most of the sectors with high and very high import protection, notably agricultural products and the textile and clothing sectors protected by specific tariffs..

All of this suggests that there is no compelling case for India to pursue an FTA with Bangladesh, based on the potential economic welfare benefits to India. Whatever economic benefits might result from an FTA with Bangladesh, are potentially available on a much broader basis and larger scale from continuing the general unilateral import liberalization process that has been under way during the past three years. This would pay special attention to non-tariff barriers and prohibitive tariffs in the agricultural sector (including livestock and fisheries products and processed foods) and to the specific duties protecting the textile and clothing sectors.

India-Bangladesh cooperation in other areas The suggestions above that both India and Bangladesh would obtain greater and more secure economic benefits by giving priority to unilateral trade liberalization on a multilateral basis, rather than by pursuing free trade arrangements, does not mean that other cooperative endeavors should be neglected. In particular there would be substantial benefits from coordinated improvements in the transport, storage and administrative infrastructures at and adjoining the India-Bangladesh land borders, as well as in harmonization and cooperation in Customs administration and banking relationships. As well as facilitating bilateral trade and reducing its cost, this would help reduce black economy activities in both countries associated with both the "bootleg" and "technical" smuggling routes, and improve fiscal resources, especially in Bangladesh. Finally, there is little doubt that regional cooperation in energy and infrastructure could yield dividends in terms of cross-border investments and joint ventures.

KEY MESSAGES

- ***India is by far the largest single source for Bangladesh's imports (15% of total in FY05), ahead of China and Singapore.*** Bangladesh's perennial large bilateral trade deficit with India might be a cause for concern but it has not led to any balance of payments problem for Bangladesh as consistent trade surpluses with such trading partners as US and EU compensate for these deficits.
- ***Movements in bilateral real effective exchange rates (REER) could significantly impact trade flows.*** There is strong evidence that appreciation of bilateral Taka/Indian Rupee REER contributed to the expansion of both formal and informal Indian exports to Bangladesh, while retarding the growth of Bangladesh exports to India, during most of the 1990s.
- ***Indian exports face import weighted Bangladesh tariffs of about 29%, suggesting that they compete favourably with imports from the rest of the world.*** Though protection remains high with para-tariffs being imposed on top of custom duties, India is able to export a wide range of products to Bangladesh covering all but 4 of the 98 HS chapters. Bangladesh granted few – mostly symbolic -- tariff concessions to India under SAPTA.
- ***India's specific tariffs on Bangladesh's major exports (RMG) make it difficult for such exports to penetrate the Indian market.*** Though industrial tariffs in India are now mostly at 15%, most Bangladesh exports face 7.5% tariffs under SAPTA. Yet exports are negligible suggesting they face stiff competition from domestic production and ROW exports.
- ***Bangladesh exports a miniscule (<1%) share of India's imports,*** a negligible share (1%) of its own exports, and a small range of products (fertilizer and jute goods made up two-thirds of exports). Bangladesh exports might have been restrained by (a) faster productivity growth in India bolstering its comparative advantage in competing goods, and/or (b) tariff and non-tariff barriers constraining Bangladesh's major exports (RMG) or minor exports, which have experienced rapid growth elsewhere. India uses WTO-compliant measures – e.g. anti-dumping, standards – for “contingent” protection which could pose as non-tariff barriers to imports from Bangladesh.
- ***The large volume of informal/illegal trade remains a problem*** magnified by poor logistics and infrastructure at land border posts that prompts higher transaction costs for formal imports. Cross-border and technical smuggling are further encouraged when both India and Bangladesh restrict imports over land border via designated ports.
- ***Informal trade is substantial but difficult to measure because of its clandestine nature.*** Informal and illegal trade between India and Bangladesh, by some estimates, could be as high as three quarters of recorded trade. It is mostly one way -- from India to Bangladesh. Quite apart from the well-known cross-border informal trade, this study notes the existence of significant volumes of illegal imports into Bangladesh through legal channels (technical smuggling) by under-invoicing, misclassification, and bribery of customs.
- ***The study finds that preferences for formal trade will be influenced by the levels of Bangladesh protective tariffs, rigor of customs administration, and the state of infrastructure*** at border posts (roads, storage, technical and administrative capabilities). To reduce informal/illegal imports, both countries need to (a) improve infrastructure – physical and administrative – at land border customs posts; (b) streamline and harmonize customs procedures and administration; (c) expand facilities at smaller customs border

posts; and (d) for Bangladesh, bring down the high protective tariffs. Trade Liberalization Programme under SAFTA could facilitate this process.

- ***Trade financing is weak and transaction costs remain high.*** A sub-components of this study on the financing of India-Bangladesh trade points out that the hawala networks perform better than the formal banking system in terms of simplicity, speed, transaction costs, and reliability, and that for these reasons they are not only financing much of the informal bootleg smuggling trade from India to Bangladesh, but also substantial parts of the exports to Bangladesh that go through the legal routes. In practice, “the LC is a mere cover to move goods through Customs”, finds this study. If this is correct, they involve non-negligible transaction costs without protecting the suppliers and importers against commercial risks such as defective shipments, non-payment, delayed payments etc.

Though SAFTA has been signed and ratified by the two countries, the possibility of a bilateral FTA between India and Bangladesh has been mooted and pursued with more or less vigour at different times. The economic implications of such an arrangement have not been clearly spelled out in the public discourse. The present study develops a methodology, by using industry case studies, to quantify the economic welfare implications of an FTA between the two countries.

- ***Free trade agreements discriminate against imports from rest of the world (ROW)*** and, in so far as the imports from the ROW countries that are excluded are traded at lower prices than the imports from the FTA countries, there is an economic welfare loss for the FTA members, and also an economic loss for the ROW exporters who lose their markets. These trade diversion effects need to be allowed for in any comprehensive evaluation of the costs and benefits of FTAs.

- For the few industry case studies simulated (cement, light bulbs, sugar, readymade garments) the likely effects of an FTA, for the first three, seem to be an expansion of Indian exports to Bangladesh, but no exports from Bangladesh to India. This was mainly because Indian export prices for these products were substantially lower than ex-factory before-tax prices of the same or similar products in Bangladesh. The simulations for ready made garments predict increased Bangladesh exports to India, but also increased RMG exports from India to Bangladesh.

Policy implications of FTA

- ***For Bangladesh:*** Consumer welfare gains far outweigh losses in government revenue or producer surplus, provided infrastructure and administrative capacities are expanded at the borders. Yet, welfare gains could vanish if, after getting a captive protected market under an FTA, Indian producers collude amongst themselves or with Bangladeshi importers. Bangladesh would be better served in pursuing similar welfare gains from multilateral liberalization.

- ***For India:*** India’s trade with Bangladesh is rather small relative to its total trade such that the economic welfare gains from an FTA are modest, largely stemming from gains in producer surplus due to expanded exports. India stands to gain from the continuation of its policies of unilateral liberalization paying special attention to the removal of non-tariff barriers, specific duties on textiles and garments, and prohibitive tariffs on agricultural products.

- ***India-Bangladesh cooperation in other areas.*** FTA or not, the study finds substantial benefits from coordinated improvements in the transport, storage and administrative infrastructures at and adjoining the India-Bangladesh land borders, as well as in harmonization and cooperation in Customs administration and banking relationships.

Introduction

The trading relationship between India and Bangladesh is currently of special interest in both countries for a number of reasons. Firstly, there are urgent and longstanding concerns in Bangladesh arising from the perennial, large bilateral trade deficit with India, and from the large volumes of informal imports from India across the land border which avoid Bangladesh import duties. These concerns have been particularly acute on the Bangladesh side in the context of discussions between the two governments of the possibility of a bilateral free trade agreement along the lines of the India-Sri Lanka FTA. Secondly, even though (because of the disparity in the size of the two economies) India's trading relationship with Bangladesh is much less significant for it than it is for Bangladesh, closer economic integration with Bangladesh is nevertheless seen as a very important way of reducing the economic and political isolation of the seven Indian eastern and north eastern states from the rest of the country. Finally, both countries have long shared common objectives for closer economic integration within the South Asia region, and these have recently been reemphasised by signing on to SAFTA⁴, which takes effect from January 2006. Under SAFTA, the preferential tariffs agreed in the various rounds of SAPTA⁵-so far largely ineffective in generating much intra-regional trade- will continue, but a number of ambitious new objectives have been enunciated. These include the eventual elimination of tariffs and non-tariff barriers on trade between the members, the harmonisation of Customs procedures and documentation, the facilitation of banking relationships, and cooperation and improvements in the infrastructure for regional trade.

This paper summarizes and attempts to draw out and synthesize some of the main conclusions of a series of consultant papers on various aspects of the trading relationship between India and Bangladesh. The consultant studies cover the following topics:

- A comparison and analysis of Indian-Bangladesh trade using official statistics, and other statistical sources and publications, including a summary of existing studies of informal India-Bangladesh trade
- The collation of information on a sample of products and industries in India and Bangladesh in order to assess the potential for trade between the two countries (e.g. under an FTA)
- Smuggled imports from India in Bangladesh (both "bootleg" and "official" smuggling)
- A paper on a partial equilibrium empirical methodology for simulating the economic welfare consequences of an India-Bangladesh FTA at the level of individual industries
- Case studies of a number of industries applying the economic welfare methodology and providing illustrative quantitative simulations of changes in economic welfare summarized as changes in consumer welfare (consumers' surplus), producer welfare (producers' surpluses) and government revenues. These changes are estimated separately for both India and Bangladesh, and the likely impacts on other countries (the rest of the world) are considered but not quantified.
- Some aspects of the transport, regulatory and transaction costs of Indian exports to Bangladesh through the principal land border crossing at Petrapole-Benapole.

The study program originally also included a component which involved a summary and overview of the current situation on trade policy in each of the five principal South Asian countries (India, Pakistan, Bangladesh, Sri Lanka and Nepal) plus Bhutan and Maldives. This component became a major separate task, the results of which were published in a three volume World Bank report in September

⁴ South Asia Free Trade Area. Under the Trade Liberalization Program of SAFTA, India pares down its tariffs to 0-5% by 2013 while Bangladesh has until 2016 to do the same, subject to exclusion of sensitive lists (India's 763 tariff lines versus Bangladesh's 1254, at the 6-digit level).

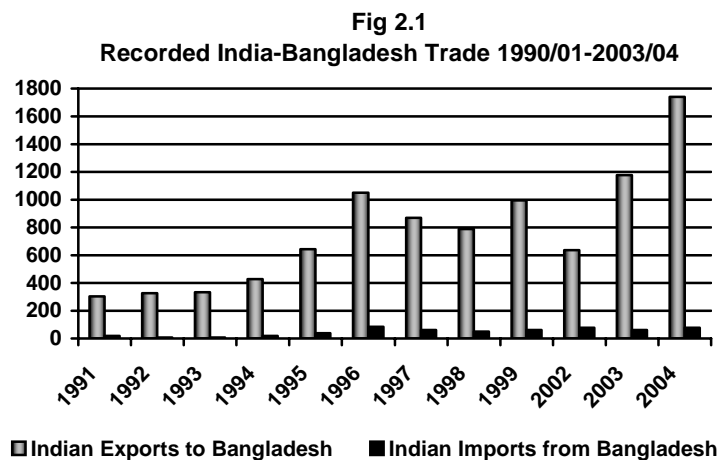
⁵ South Asia Preferential Trade Agreement. SAPTA and the other South Asian preferential trade agreements are discussed in the World Bank trade policy *Overview* report (Vol II, Ch 5).

2004 (*Trade Policies in South Asia: an Overview*) and which were discussed in a series of workshops in the region. The sections of the trade policy *Overview* report which deal with trade policies in India and Bangladesh, are important background for understanding the India-Bangladesh trade and trade policy issues that are discussed in the various consultant studies, and will be frequently referred to in this paper.

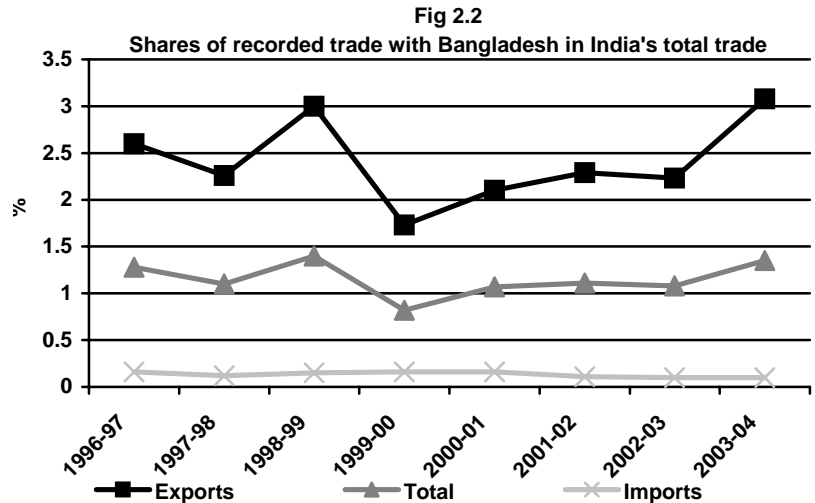
The rest of this paper is organized as follows. Section 2 deals with trends in India's and Bangladesh's real exchange rates and in their bilateral merchandise trade, to provide a broader perspective to the following more detailed discussion. Section 3 provides a brief update of the sections in the trade policy *Overview* report, on recent developments in India's trade policies, and this is followed in section 4 by a somewhat more extensive update of Bangladesh's trade policies. The key points that emerge from these sections are that whereas trade liberalization has had an energetic revival in India over the past three years, in Bangladesh trade policy reform slowed and in some key respects (mainly because of the increasing use of para-tariffs on top of Customs duties) the system remains as or more distortive than it had been 10 years before in the mid-1990s. Section 5 then summarizes some of the principal findings of the comparisons of the Indian and Bangladesh trade statistics and their implications for policies and trade administration, especially Customs administration. Section 6 discusses the nature and economic role of India's exports to Bangladesh and the likely effects of an FTA or substantial tariff preferences, and section 7 discusses Bangladesh's exports to India and the prospects for expanding them. This is followed by a summaries of the findings of the consultant studies on informal/illegal trade (section 8) and trade financing and trade logistics (section 9), and by an outline and interpretation of the economic welfare simulations of the industry case studies (section 10). The concluding section 11 summarizes some of the principal findings of the consultant studies that seem relevant for trade policies in India and Bangladesh, including especially policies on preferential regional trade and SAFTA, and suggests some priorities for further study and research.

Chapter 2: Background: bilateral trade and exchange rates

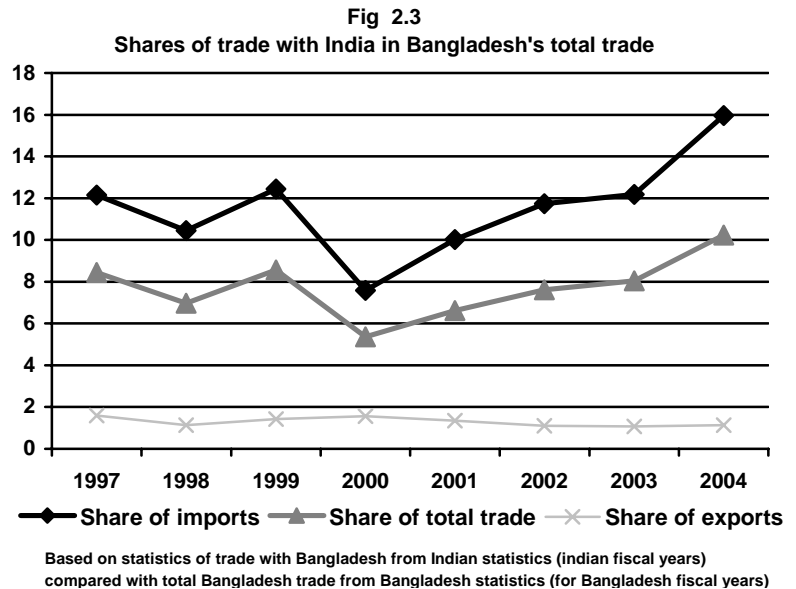
In 2004 India's officially recorded exports to Bangladesh were about \$1.7 billion but its imports from Bangladesh were just \$78 million. Indian exports to Bangladesh grew very rapidly during the 1990s, and have continued to grow since 2000 (Fig 2.1). By contrast Bangladesh exports to India-almost zero in the early 90s-have stagnated at very low levels at well below \$100 million annually. In inflation adjusted US dollars they are presently about the same as they were 20 years ago during the 1980s. Since 1996/97 Indian exports to Bangladesh (in nominal US dollars) have been growing at 9.1% annually, just slightly above the general rate of growth of its total merchandise exports (8.4%), but India's imports from Bangladesh over the same period have grown on average at only 3% annually, compared to average growth of its total imports of 9.2%. Consequently Bangladesh's bilateral trade deficit with India has been increasing rapidly, on average at about 9.5 % annually.



For India, trade with Bangladesh is a very small part of its total trade—just over one percent since the mid-1990s, and currently about 3 percent of its total exports and a minuscule share (0.01%) of its total imports (Fig 2.2). For Bangladesh (Fig 2.3) however, India has now become the largest single source of its imports (about 16% of the total, ahead of China and Singapore) and accounts for about a tenth of its total trade, despite exports to India which have declined to only slightly above 1 % of total exports.



Most Bangladesh imports from India come via the land border⁶. According to incomplete Bangladesh data, during the 1990s about three quarters of imports were by land and river, but this proportion has declined since then to between 50 and 60 percent (Fig 2.4). These statistics do not include duty free (“back to back L/C”) imports from India of inputs—mainly textiles—for Bangladesh’s export industries, but most of these probably also come by the land border. One reason for the decline in the share of the land border trade is a requirement imposed by Bangladesh in July 2002 that two major imports from India—sugar and textile yarns—could henceforth only be imported by sea. The reason given for these measures was the control of illegal activities and smuggling at or near the land border Customs posts, and immediately afterwards there was a big jump in officially recorded imports of sugar from India which presumably came by sea⁷. However, a more basic reason for the decline in the share of the land border trade is increasing congestion and delays at the land border crossings—especially at Petrapole-Benapole—as a result of inadequate infrastructure and administrative capacity on both the Indian and the Bangladesh sides, in the face of rapidly increasing total volumes of trade.



Studies of informal trade between India and Bangladesh have consistently found a similar pattern to the pattern of formal trade i.e. large volumes of goods being smuggled from India to Bangladesh, but much smaller volumes being smuggled in the other direction. This general conclusion that there is also a substantial Indian trade surplus on informal account, is confirmed once again in the studies done as part of this project.

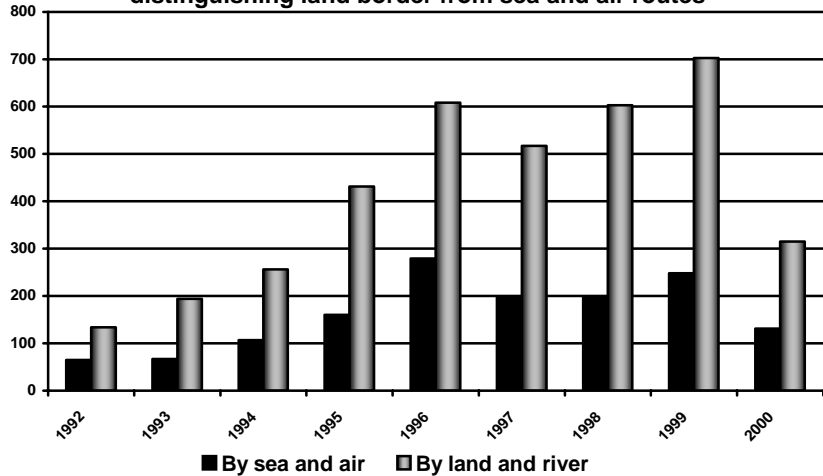
⁶ We were unable to obtain equivalent statistics on the land/sea breakdown of Bangladesh exports to India.

⁷ There is no product breakdown of the land border and sea trade. The consultant studies did not report Indian statistics distinguishing the land and sea trade with Bangladesh

In the past, a major reason for the expansion of Indian exports to Bangladesh (and also to the other South Asian countries) was the massive devaluation of the Indian Rupee, which started in about 1985 and finished in 1992. The Rupee devaluation (Fig 2.5) up to 1992 supported India's trade liberalization during this period, and is best interpreted as a return to a more normal and economically efficient situation, following many years of extreme exchange rate overvaluation, during which India's exports to the world as a whole, including the other South Asian countries, were taxed and compressed. Since 1992 the real value of the Rupee (as indicated by the Rupee REER index) has been kept at approximately the same level, with adjustments of the nominal exchange rate offsetting differences in inflation in India and average inflation in its trading partners. While this was happening, the real value of the Bangladesh Taka (Fig 2.6) moved within a fairly narrow band of about 10% around trends of slow devaluation from 1980 up to 1996, modest appreciation from 1997 to 1999, followed by slow but steady devaluation which was still continuing in early 2005. The strength of the Taka since the mid-1980s has

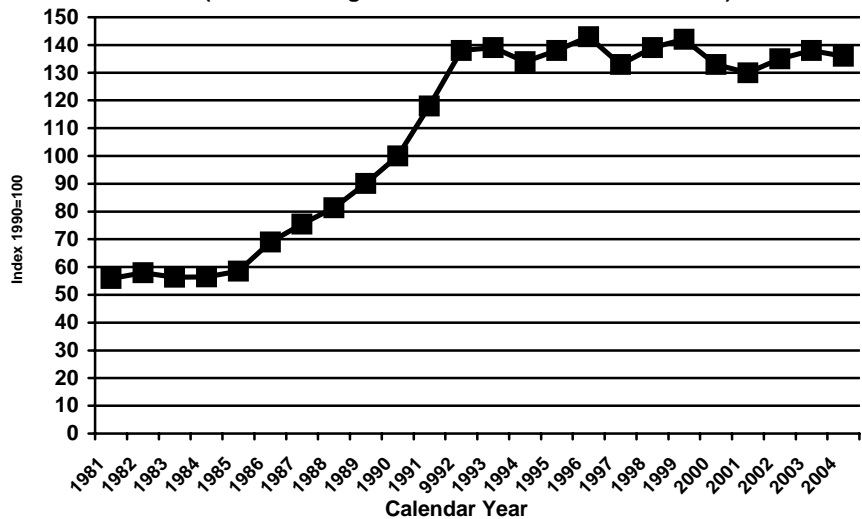
reflected the strong growth of ready made garment exports and of remittances from Bangladeshis working outside the country, which together have been sufficient to balance increases in imports resulting from import liberalisation measures, especially the removal of many QRs and the reduction of tariffs in the early 1990s. However, one consequence of the relatively stable Taka alongside the devaluation of the Rupee between 1985 and 1992, was that the Taka/Rupee rate appreciated in real terms by about 30% (Fig 2.6). This appreciating trend of the real Taka/Rupee exchange rate continued at a slower pace until, in 1999, the total real appreciation of the Taka in relation to the Rupee was about 50%, compared to its value in the mid 1980s. Since about 1999, this trend has been reversed, with the real Taka/Rupee exchange rate devaluing on average at about 4 % per year, about the same as the average rate of real devaluation of the Taka viz a viz the rest of the world.

Fig 2.4
Bangladesh imports from India FY 1992-2004:
distinguishing land border from sea and air routes



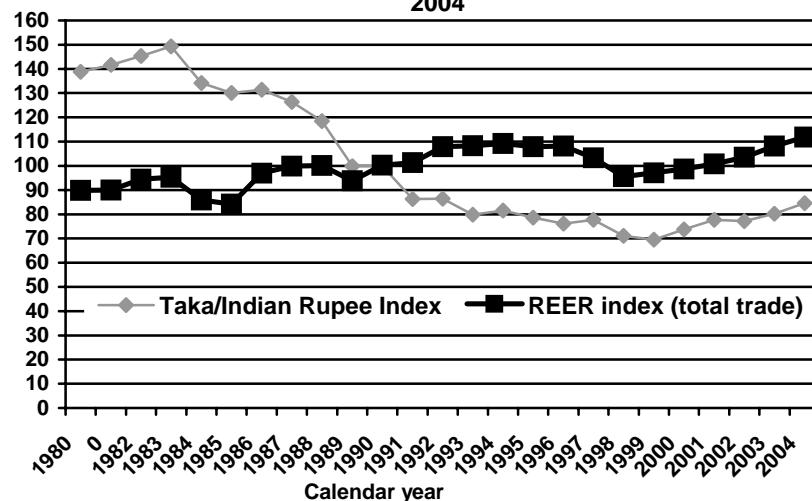
Note: data is for Bangladesh fiscal years. It excludes Indian duty free exports used as inputs by Bangladesh exporters ("Back to Back LC imports") and imports through some small land border customs posts.

Fig 2.5
India Real Effective Exchange Rate Index 1980-2004
(Annual averages 1990=100: Increase=devaluation)



The persistent and substantial appreciation of the real Taka/Rupee exchange rate from the mid-1980s up to about 1999, combined with Bangladesh's liberalization of its import policies, are plausibly important reasons for the expansion of recorded formal Indian exports to Bangladesh over this period. Conversely, the Taka appreciation would have retarded the growth of formal, recorded Bangladesh exports to India during the same period. However, as noted above, recorded Bangladesh imports from India have grown even more rapidly since the exchange rate

Fig 2.6
Bangladesh Real Exchange Rate Indices 1980-2004



trend was reversed after 1999, and Bangladesh exports to India have continued to stagnate. This is consistent with observations in a number of the consultant studies that efficiency and productivity have been growing in India, especially in Indian manufacturing, resulting in an acceleration of general export growth, a very small part of which has consisted in rapid growth of exports to Bangladesh. Faster productivity growth in India would have also increased the difficulty of Bangladesh exports competing there, offsetting the favourable trend in the exchange rate since 1999. This is also consistent with the consultant studies, which for a sample of products found that most prices-especially prices of manufactured goods-were markedly higher in Bangladesh than in India.

Rupee devaluation and faster productivity growth in India would also tend to increase informal Indian exports to Bangladesh, while retarding informal Bangladesh exports to India. However, in this case import liberalisation would be expected to divert some of the growth of informal trade into formal channels. There is support for this latter hypothesis in the study on informal trade, which finds that informal imports from India had somewhat declined in absolute terms compared to informal imports estimated by earlier studies, but were markedly lower relative to the total volume of formal recorded imports from India.

In popular discussions of economic policy in Bangladesh, some groups see the bilateral trade deficit with India as a problem, and use it to argue against both general trade liberalisation, and preferential or free trade with India. However, the trade deficit with India has been consistently offset by trade surpluses with other countries, especially with the US and the EU, and by worker remittances. These surpluses have in turn supported the exchange rate of the Taka with other currencies, including the Taka/Rupee rate, and have both enabled, and have been a consequence of, macroeconomic policies which have avoided destabilizing fluctuations in the balance of payments, domestic prices and the exchange rate. As in other countries, there is no economic logic in the idea that trade should be balanced with individual trading partners, and the real concerns behind contrary arguments are usually efforts to prevent or moderate import competition.⁸

⁸ Bangladesh also consistently runs large trade deficits with developing countries in East and South East Asia. In this respect the Bangladesh public debate on trade which focuses on the trade deficit with India, resembles the US public discussions on the US bilateral trade deficit with China.

Alongside popular concerns in Bangladesh about the trade deficit with India, it is also often argued that the deficit is aggravated by protectionist policies that have hobbled Bangladesh exports to India. However, as noted above, for the past 8 years India's imports from the world as a whole have been growing at over 9 percent a year: on average, each year's increase in imports has been exceeding Bangladesh's total exports. Many of these imports have been coming in over considerably higher tariffs than the tariffs faced by Bangladesh exporters, owing to the extensive tariff preferences given to Bangladesh by India under SAPTA, and to the extent that there are non-tariff and bureaucratic barriers, they are probably more constraining than the ones that Bangladesh would face⁹. This suggests that the low level and slow growth of Bangladesh's exports to India reflect fundamental comparative advantage factors, not discriminatory import policies.

This issue is also considered in the consultant studies in the light of what is likely to happen were there free trade between India and Bangladesh. The general finding of the studies is that some aspects of India's import regime are retarding Bangladesh exports, but that in the short and medium run the potential for expanded exports to India is not very great, even under an FTA or with the full implementation of SAFTA. On the other hand the studies also find very recent and strong protectionist trends in Bangladesh's import policies which are a major constraint on Bangladesh imports in general and which, if still enforced against the rest of the world during an FTA with India, would lead to a large expansion of imports from India and an increase in Bangladesh's bilateral trade deficit.

⁹ An example is Indian anti-dumping, which has been concentrated on developing countries, especially China and other East and South East Asian countries. For the products which it affects, it provides protection in the Indian market for exporters in countries not subject to anti-dumping duties. See further discussion in section 3 below.

Chapter 3: India's trade policies

There is a detailed description and analysis of India's trade policies in the World Bank trade policy *Overview* report. This section summarizes and updates some of the principal findings of that report, and expands on some aspects that relevant for India's trade with Bangladesh.

Non-tariff barriers to imports. During the 1980s and before India had a comprehensive import licensing system under which imports of many products were effectively banned and most others were subject to stringent import licensing. The principal exceptions were inputs needed by exporters and a number of "essential" products such as foodgrains, that could only be imported by government import monopolies. The restrictions on imports of raw materials and manufactured intermediates were removed during India's 1991/92 reforms, but imports of nearly all industrial consumer goods and agricultural products continued to be restricted, either by import licensing which operated as a *de facto* import ban in most cases, or-especially in the agricultural sector- by "canalisation" through parastatals such as FCI. Among other things these import restrictions hobbled SAPTA, especially in the first two negotiating rounds in 1995 and 1997, when the other South Asian countries complained that it was meaningless for India to grant tariff preferences when the same products were subject to import licensing. In response to these complaints, in 1998 India exempted the SAARC countries from its general system of import licensing. At about the same time (following pressure at the WTO) it started removing these controls viz a viz the rest of the world, and the final 715 tariff lines were freed on April 1, 2001.

Against a background of almost 40 years of *de facto* autarchy, the abolition of this comprehensive import licensing system created considerable apprehension as to how well local producers of industrial consumer goods and of agricultural products would be able to compete with imports. Partly because of this apprehension, after the Uruguay Round, India made sure that it implemented all the WTO-compatible procedures that allow non-tariff restrictions to be applied to imports. These include in particular, government-mandated import monopolies or State Trading Enterprises (STEs), tariff rate quotas (TRQs) applied to a number of agricultural commodities, technical standards and regulations implemented by the Bureau of Indian Standards (BIS), sanitary and phyto-sanitary (SPS) rules mainly applied to agricultural and food products, other health and safety regulations, and anti-dumping. In May 2001 a "War Room" was established in the Ministry of Commerce, and a list of 300 "sensitive" consumer products was published, imports of which were subsequently regularly monitored so as to be able to take prompt action to pre-empt or minimize disruption caused by imports to local producers,

During the past few years, discussions of trade and other policies in India have begun to recognize that the earlier concerns about the ability of local producers to compete without protection from the import licensing system and/or from high tariffs were vastly exaggerated, and there is new confidence in the competitiveness of Indian producers, as evidenced by rapidly growing exports and foreign exchange reserves, and faster overall economic growth. Along with these new perceptions, there are signs of some consequent relaxation of the vigilance with which the various non-tariff protective measures are being pursued¹⁰. These changed attitudes have also underpinned the dramatic reductions in industrial tariffs which started in 2002/03 and are described below.

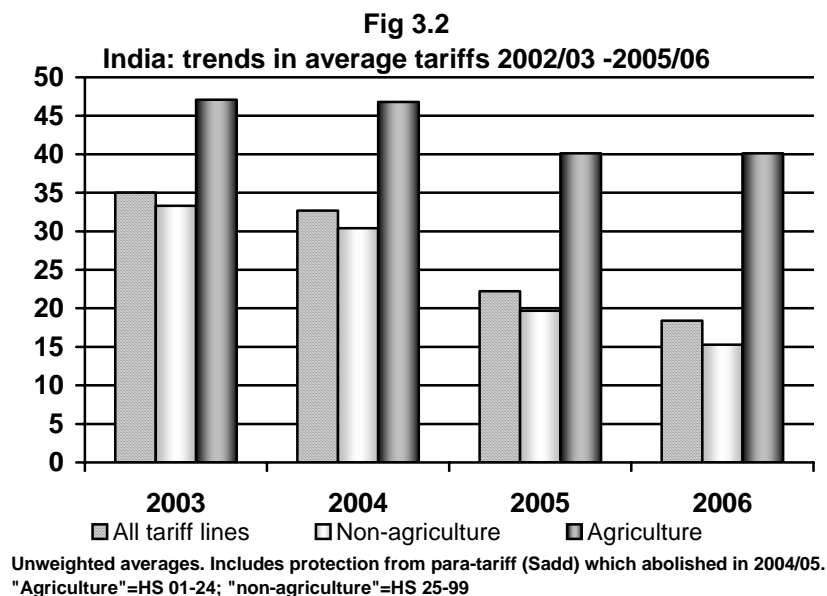
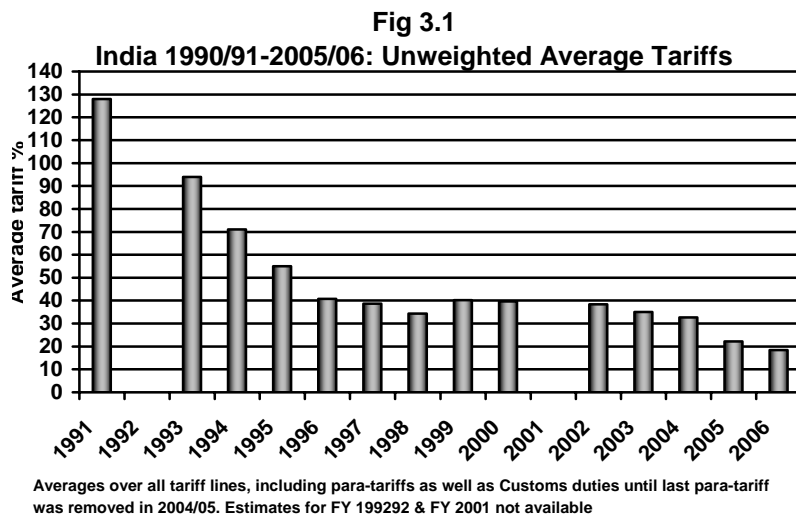
¹⁰ For example, the "sensitive list" of products has been removed from the Ministry of Commerce (DGFT) website, reportedly because (for most products on the list) despite tariff reductions, there have been few imports to monitor. In addition, some important products (notably a number of steel products) have been omitted from the list of products requiring compulsory BIS certification, and anti-dumping activity appears to have slowed.

Customs clearance at land border Customs posts India has 83 Customs posts on its land borders with Bangladesh. All except three are formally authorized to clear all kinds of exports and imports¹¹. This contrasts with Bangladesh's land border Customs posts, only four of which have unrestricted clearance powers for imports from India (see section 4 below). Whether all of the Indian Customs posts actually have the capacity for unlimited clearance is another matter, since legal exports of many Indian products are obliged to go by the few land border crossings-especially Petrapole-Benapole-at which the Bangladesh customs posts are authorised to clear them.

Tariffs. As well as removing QRs from intermediates and capital goods, the 1991/92 reforms reduced tariffs and pre-announced a tariff reduction program. Under this program tariffs came down steadily from prohibitive levels at the beginning (average almost 130% in 1990/91) to much lower levels (average about 35%) in 1997/98 (Fig 3.1). Then, in large measure to compensate for the removal of the consumer good QRs, during the following four years this downward move was reversed and tariffs went up. In 2000, this upward trend was supplemented by the introduction of prohibitively high specific tariffs to protect textile fabric and garment producers.

However, only a year after the final removal of import licensing, a new tariff reduction process started in 2002/03. This new program focussed on industrial tariffs. There were three major omissions:

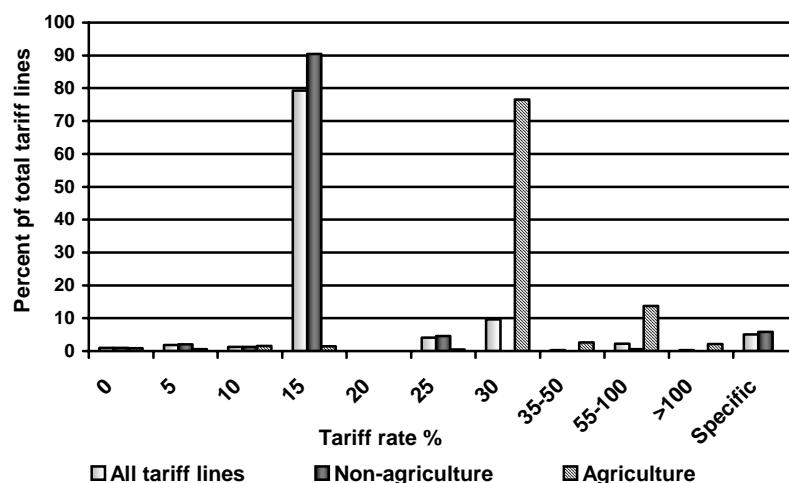
- Agriculture, livestock, fisheries and processed foods (HS 01-24)
- Textile fabrics and clothing products, about half of which continue to be protected by specific tariffs
- A few important manufacturing sectors, notably the auto and fertilizer industries



¹¹ Customs notification No 63/94-Cus.(N.T)

For most industrial goods, there was an especially large tariff reduction in 2004/05 resulting from a cut in the generally applied maximum Customs duty accompanied by the abolition of the Sadd¹², the one remaining para-tariff¹³. This was followed by a further cut in the maximum industrial tariff to 15% in 2005/06, and to 12.5% in 2006/07. Without counting the specific textile and clothing tariffs, during the four years average industrial tariffs fell by more than half to 15.3%. Moreover, the compression of tariffs as the ceiling came down greatly reduced their variance: before allowing for the specific

Fig 3.3
India 2005/06
Distribution of tariff lines



tariffs, **90 percent of industrial tariffs are now¹⁴ at 15%** (Fig 3.3), **far lower and far more uniform than they have ever been in the past 50 years.** Even after allowing for the specific textile and clothing tariffs and assuming that these all involve *ad valorem* equivalent rates in excess of 15%, almost 85% of industrial tariffs are at the uniform 15% rate. Moreover, the decline in the maximum tariff has made large numbers of *ad hoc* reductions for particular users or uses irrelevant, and has been accompanied by major simplifications of the tariff schedule in which many of these have been eliminated¹⁵. For many Indian manufacturing industries, with their domestic sales protected by a 15% tariff against imports, and buying from domestic suppliers also protected by 15% tariffs or importing inputs over a 15% tariff, effective protection to their processing margins in the domestic market is also around 15%, far lower than the effective protection rates that were generally available from the tariff structure only three or four years ago, and only slightly above the processing margins available from exporting. Consequently, relative to selling in the domestic market, exporting is now much more attractive for Indian firms than it was even in the recent past. From the perspective of SAARC countries including Bangladesh, these changes mean that Indian domestic markets for most manufactured goods are highly competitive, with prices that are close to world prices, and are likely to be difficult to penetrate even with complete exemption from Indian tariffs under bilateral or multilateral free trade arrangements such as those planned under SAFTA.

<i>Tariff</i>	<i>% share of 10,558 non-agricultural tariff lines (HS 25-99)</i>
<15%	4.3
15%	84.6
>15%	5.3
Specific & >15%	5.8

¹² Special additional duty: prior to its abolition, 4% of the assessable value of an import plus Customs duty plus additional duty

¹³ A very small “education cess” equal to 2% of (Customs duties plus additional duties) was introduced in July 2004. With a Customs duty of 15% and the normal 16% additional duty, this is equivalent to 0.67% of the cif price. It is ignored in the rest of this paper

¹⁴ In fiscal year 2006/07, 90 percent of industrial tariffs are at 12.5%.

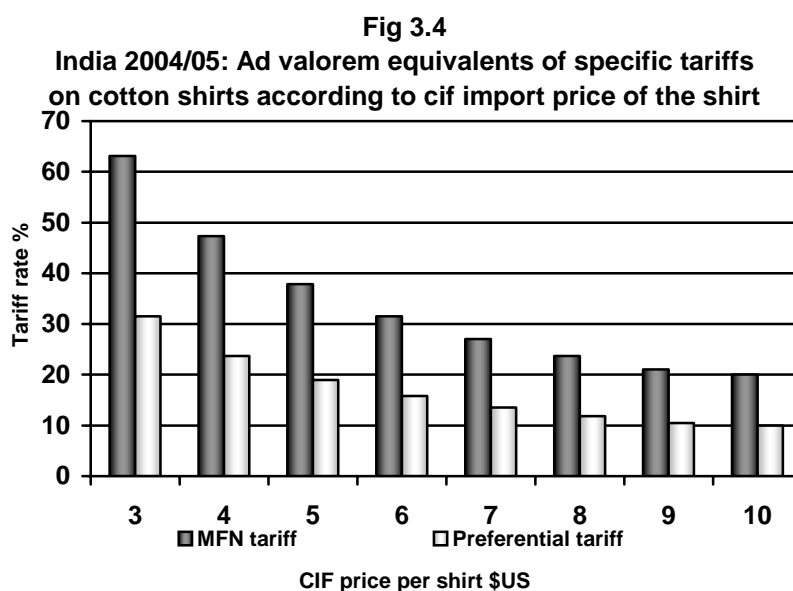
¹⁵ In particular, many items have been removed from the annual “Jumbo” exemption notification. As discussed in the trade policy *Overview* report (Vol II, p.41), these *ad hoc* exemptions and partial exemptions have long been a source of complexity and opacity in Indian trade policies.

In contrast to industrial tariffs, tariffs on “agricultural” products (defined in the broad sense to include fisheries, livestock and livestock products, agricultural products and processed foods) were left out of the new tariff reduction program: they came down just a bit in 2004/05 but in 2005/06 on average they were about 40%, almost three times the level of non-agricultural tariffs (Fig 3.2). They are also much more dispersed than industrial tariffs (Fig 3.3): just over three quarters are at 30%, but there are many very high tariffs, with 13.7% of the total tariff lines subject to tariffs of between 50% and 100%, and 2.1% of tariff lines with tariffs well over 100%. As in Bangladesh (see discussion in the next section) there are high tariffs protecting domestic production of processed foods, and also therefore this section of the manufacturing sector.

<i>HS chapter</i>	<i>Processed food products included in the HS chapters</i>	<i>Average tariff %</i>
04	Dairy products, eggs, honey etc	34.1
15	Animal & vegetable fats and oils etc	75.5
16	Preparations of meat, fish, crustaceans etc	34.1
17	Sugar and sugar confectionery	35.4
18	Cocoa and cocoa preparations	30.0
19	Preparations of cereals, starch or milk; pastry cook products	31.2
20	Preparations of vegetables, fruits, nuts, etc	30.2
21	Miscellaneous edible preparations	30.0
	Average of 8 processed food chapters	37.6

In addition government import monopolies have continued for all the foodgrains except maize and barley, and tariff rate quotas are used to regulate imports of powdered milk, maize, crude sunflower and safflower oils, and refined rape, mustard, colza and mustard oils. Hence, in these sectors there are extensive barriers against import competition, even though (as discussed in the trade policy *Overview* report¹⁶) domestic prices of many agricultural commodities-including for example the principal food grains and sugar-in most years are not very different from world prices.

Specific duties protecting the textile and garment industries Just before the withdrawal of import licensing from textiles and garments in April 2001, the government imposed specific duties on a large number of textile fabrics and garments, in order to protect domestic producers against low price import competition. The specific duties are applied to approximately 41% of the fabric and clothing tariff lines in the textile and clothing HS chapters (chapters 50-63)¹⁷. At present these tariffs are the greater of the standard 15% rate, or the specific amount (usually Rupees per metre of per kg, or per garment). The ad valorem equivalent of these duties varies with the cif price: for example (see



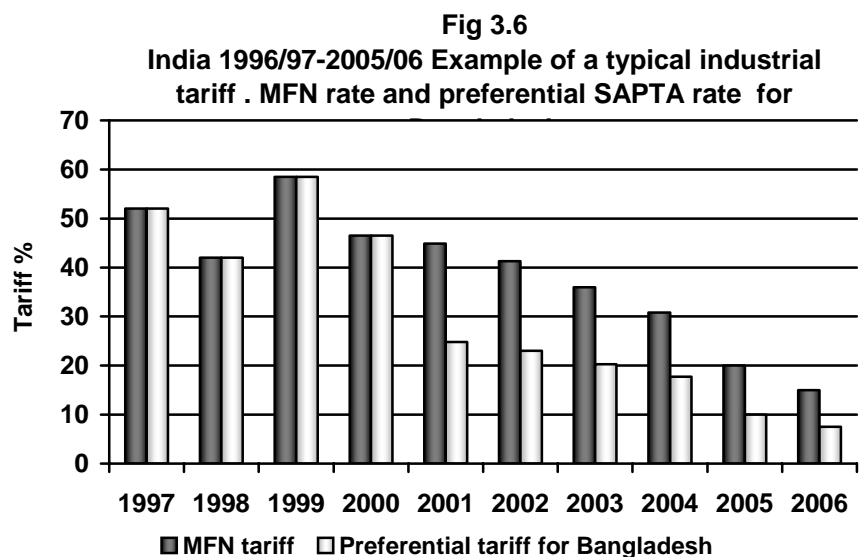
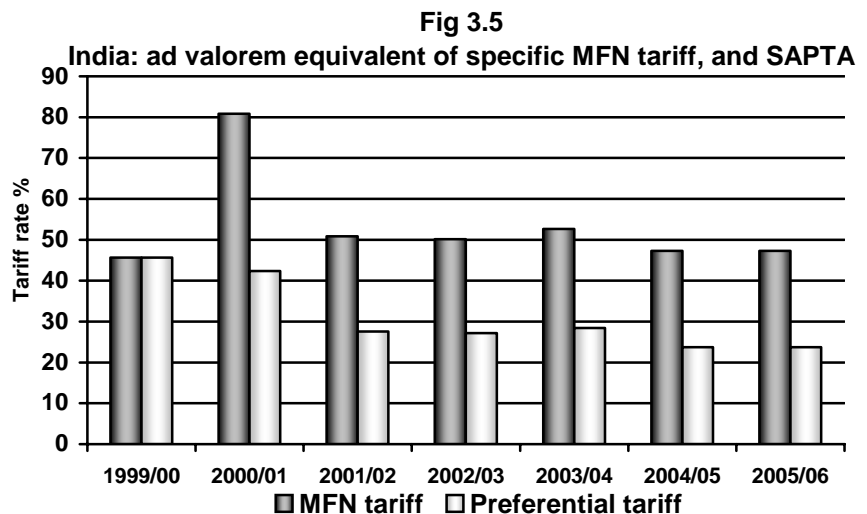
¹⁶ See especially Vol III, pp 10-12.

¹⁷ For more on the India’s specific tariffs, see the chapter on textiles and garments in the trade policy *Overview* report (Vol III, Ch 3, pp 63-64 and Appendix tables)

Fig 3.4) for a man's cotton shirt, at prevailing world prices of \$3 to \$4 per shirt, it is equivalent to an *ad valorem* MFN tariff of between 63% and 47%: only for luxury brands selling at well over \$10 cif per shirt would the 15% ad valorem become the operative tariff. This system was designed to make it impossible or very difficult for other developing countries with strong textile and garment industries to compete in India. It also has the effect of excluding the products to which the specific duties are applied, from subsequent reductions in *ad valorem* tariffs. For example (Fig 3.5) between 2000/2001 and 2005/2006 the *ad valorem* equivalent of the specific duty on a \$4 man's shirt has remained at or just slightly below 50% since 2001/02, even though the regular *ad valorem* tariff on the shirt went down from about 45% to 15% during the same period.

Ready made garments are Bangladesh's principal export, and these specific tariffs in India are of special concern to it in the context of regional trade arrangements including SAPTA and SAFTA. The SAPTA preferences are applied to specific as well as ad valorem duties, but-as is the case with the MFN duties-the ad valorem equivalents for standard low price imports are much higher than the preferential ad valorem rates, and their use has also excluded the products to which they are applied from India's general tariff reduction programs (as illustrated in Fig 3.5). To continue the example of mens' cotton shirts, without the specific duty the preferential tariff for Bangladesh would be 7.5%, but in 2004/05 the preferential specific tariff was equivalent to an ad valorem tariff of 31.6% on a \$3 shirt, and to a tariff of 23.7% on a \$4 shirt (Fig 3.4). As discussed in the case study of the RMG industry, given the low margins between fabric costs and garment export prices, tariffs at this level make it very difficult for Bangladesh RMG exporters to compete in India

India's SAPTA preferences for Bangladesh, Nepal, Bhutan and Maldives are "less developed" (LDCs) members of SAPTA, and the more developed members (India, Pakistan and Sri Lanka) can extend tariff preferences to them without being obliged to extend the same preferences to the other more developed members. At present India has given preferences to Bangladesh on approximately 2925 tariff lines, about 58% of the total number of its approximately



5000 6-digit HS lines¹⁸. Two thirds of these preferences were agreed in the third SAPTA negotiating round and came into force during India's 2000/01 fiscal year. A majority of the preferences are special "LDC-only" preferences: most of these are 50%, some are 60%, and a few 15%, 75% or 100%. The others are preferences also given to the "developed" SAPTA members i.e. to Sri Lanka and Pakistan, and most of these are less generous-10% or 15%: only a few are as high as 50%.

In India, the SAPTA preferences are applied to Customs duties (both ad valorem and specific) but were not applied to the Sadd duty: consequently, before the Sadd was abolished in 2004/05, the preferential protective rates for Bangladesh resulting from a typical 50% SAPTA preference, were in fact more than 50% of the general MFN rate. The preferences are scattered through 53 of the 97 HS chapters, so there are no SAPTA preferences for products covered by 44 of the 97 chapters. In practice Bangladesh is the only relevant beneficiary of India's LDC-only SAPTA preferences, since Nepal and Bhutan have long had duty free access to the Indian market under their bilateral treaties, and the Maldives trade is negligibly small (at least from India's perspective). Therefore, in a sense, these preferences constitute a *de facto* bilateral asymmetric preferential trade arrangement between India and Bangladesh, asymmetric because many substantial preferences have been given by India, but for all practical purposes few and negligible preferences for Indian imports have been given by Bangladesh (see discussion in the next section).

In order to qualify for India's SAPTA preferences, products imported from Bangladesh would have to satisfy the SAPTA origin rule, which is that the cif value of non-SAPTA imported inputs included in the exported product should not exceed 70% of the fob price, or put another way, that national value added should be no less than 30% of the fob price. In this respect Bangladesh has an advantage over the "developed" SAPTA members (India, Pakistan and Sri Lanka) for which the minimum value-added ratio is 40%. Both were reduced (from 40% and 50% respectively) in November 2000, mainly in response to complaints from the SAPTA members other than India, that the rules were too stringent. However, there was already some built-in flexibility from a provision that excludes inputs obtained in other SAPTA members in calculating the imported input ratios i.e. by in effect treating such inputs as part of the value-added. As discussed in the case study of the ready made garment industry¹⁹, this provision is extremely important for firms in Bangladesh wishing to export woven garments to India, because value-added margins in cutting, sewing and assembling garments from imported fabrics are typically around 30% of fob prices, and may be less. If these firms use fabrics imported from China or other non-SAPTA countries, this limits their ability to compete in exporting to India, because if they cut their export prices they may breach the rule of origin conditions and find that these shipments are subject to the higher MFN tariffs in India, rather than the lower SAPTA preferential tariffs. To get around this constraint, they can use imported Indian fabrics, even though they might not have done so if they had a free choice unconstrained by this consideration²⁰.

Fig 3.6 illustrates how India's SAPTA preferences for Bangladesh have developed since 1996/97, using the example of a typical industrial product subject to India's general maximum Customs duty and the para-tariffs that were applied up to 2003/04, and assuming a 50% tariff preference for Bangladesh during 2000/01 and after. This example brings out a number of points that are relevant for interpreting the stagnation of Bangladesh exports to India during this period.

¹⁸ Rajesh Mehta (op cit) p.8. These shares of tariff lines with SAPTA preferences were estimated using HS 6-digit tariff lines. These have now been replaced in India with an 8-digit classification and the shares calculated on this basis may have changed somewhat.

¹⁹ Garry Pursell (2005, March). *Free Trade between India and Bangladesh? A Study of the Ready Made Garment Industry*.

²⁰ In principle it would seem that Bangladesh woven garment exporters could also satisfy the origin rule by importing fabrics from Pakistan. India and Pakistan are the only SAPTA members with substantial export-oriented textile industries.

- Between 1996/97 and 1999/2000 there were relatively few products with preferences. Imports from Bangladesh without preferences would have had to compete in India with domestic producers after paying tariffs which ranged from just over 40% to almost 60% during these years. Products with preferences (not indicated in the diagram) would have still been subject to tariffs which varied between 20 and 30 percent during the period. For three of these years (1997/98, 1998/99, and 1999/2000) Bangladesh exporters of consumer goods were exempt from India's import licensing system and in this respect had a major advantage over exporters from non-SAARC countries, but it seems that the Indian tariffs (whether or not reduced by preferences) were too high for them to take advantage of this opportunity
- After 2000/01 there was a big increase in the number of products with tariff preferences for Bangladesh, and this is illustrated in Fig 3.6 by the introduction of a preferential tariff for Bangladesh in this year. Since 2000/01 both MFN tariffs and the corresponding lower preferential tariffs for Bangladesh have steadily declined. From the viewpoint of Indian traders, this would have made importing from both Bangladesh and the rest of the world more attractive, relative to buying from local suppliers, with a substantial margin of preference for imports from Bangladesh. However, up to 2003/04 only Indian imports from the rest of the world have been growing, not Indian imports from Bangladesh, and this pattern was continuing in the first three quarters of 2004/05, when the MFN tariff for this representative industrial product was 20%, and the preferential tariff for Bangladesh only 10%. As already noted, this suggests that the explanations for the stagnation of Bangladesh exports to India have to do with comparative advantage and supply side factors in Bangladesh, not lack of demand or protection in India.

Anti-dumping Anti-dumping (AD) is one of the WTO-legitimate measures that India introduced during the 1990s, as a way of providing extra protection as its tariffs came down and its import licensing system was dismantled. As of June 2004, 117 anti-dumping measures were in force affecting exporters in 29 different countries and 167 different products²¹. By the late 1990s and early 2000s, India had become the world's most active user of anti-dumping. However, there are recent indications that AD activity has been slowing: the number of new cases brought during 2003/04 was 14 compared to 30 in each of the previous two years²².

In the beginning the products affected by AD were almost all intermediate goods which had been freed from QRs during the 1991/92 reforms, but Indian firms also began to bring AD cases against imports of consumer goods after QRs were also removed from them between 1998 and 2001. There is an extensive discussion of India's anti-dumping policies and practice in the World Bank trade policy *Overview* report²³. Three major points made in that discussion are:

- Nearly all products that have been subjected to AD duties were being exported to India at generally prevailing international prices. In a number of cases the Indian firms which obtained AD protection were exporting the same products at the same prevailing international prices. Whether or not that is the case is irrelevant for an AD finding: the only considerations are whether there is a "dumping margin" and whether there is "injury" to domestic firms. A "dumping margin" is defined as the excess of the product's domestic price in the exporting country, or the export price to third countries, over the export price to India.

²¹ India, Ministry of Commerce and Industry, Directorate General of Anti-Dumping and Allied Duties, *Annual Report 2003-2004*.

²² This may have been influenced by EU objections (taken up at the WTO in December 2003) to Indian AD procedures, and more generally by increasing confidence in India as to the international competitiveness of Indian industries.

²³ Op cit Vol II, pp 74-79.

- The anti-dumping duties are applied to imports from individual exporting firms. They usually vary from firm to firm and are imposed on top of normal import duties. In many cases the AD duties are prohibitively high and effectively exclude the affected firms from the Indian market.
- The texts of the AD cases make it clear that the AD duties imposed in early cases are intended as a warning to exporters in other countries to charge “fair and reasonable” prices in exporting to India. This intimidation factor may be more important in restraining import competition than the direct effects of the AD duties that are actually imposed.

What is the relevance of India’s anti-dumping for India’s imports from Bangladesh? So far, there have only been three cases involving SAARC countries, two in Nepal, and one in Bangladesh. The Bangladesh case was finalized in December 2001, and involved Indian imports of lead acid vehicle batteries from Japan, Korea, China and Bangladesh²⁴. Anti-dumping duties were imposed on all imports from the four countries, and in the case of the Bangladesh firm these were prohibitive and blocked all subsequent exports to India. The Bangladesh firm did not provide what the Indian AD Authority considered to be adequate information on its domestic prices and costs, and so the “dumping margin” was estimated from the “best information available”, which as is usual in such cases, was data on the costs and prices of the complaining Indian firms. However, the Bangladesh firm was protected by very protective high tariffs in the Bangladesh domestic market. Using a supplementary duty, these were increased from an already high level in FY 98, as follows:

<i>FY 1998</i>	47.2%
FY 2001	69.3%
FY 2003	75.3%
FY 2004	85.5%
FY 2005	72.2%

According to a spot check in Bangladesh in late 2003, actual domestic battery prices were approximating world prices plus these tariffs. This suggests that had the Bangladesh firm provided its domestic price and cost data in the form requested by the Indian AD Authority, the “dumping margin” and the AD duty determined by the AD Authority may well have been even higher than the margin and duties determined on the basis of Indian domestic costs and prices.

The key lesson from this case is that products which sell in Bangladesh at high prices made possible by high tariffs and/or other protective instruments, and are exported at much lower international prices-even if the latter are the prevailing normal prices in international trade-are vulnerable to anti-dumping actions of this kind. This is true generally for exports to all countries which have operative anti-dumping systems, even if the Bangladesh share in the importing country’s market is very small, if Bangladesh is one of a number of countries that have a larger combined market share. In this regard it is relevant to note that there is no provision in SAPTA that prevents members from taking AD action against each other, and none has so far been envisaged for SAFTA.

As regards Bangladesh’s trade with India, the large number of Indian AD cases against exporters in China and other countries, and (except for the acid battery case) the absence of AD actions against Bangladesh exporters, is an advantage for Bangladesh exporters by sheltering them to some extent from the competition of these other exporters. However, most probably this situation principally reflects the absence of Bangladesh exports. Were they to expand, even if their shares in the Indian markets of individual products were small, the exporting firms face the risk that they will be caught up in Indian AD

²⁴ Details of the case are on the Indian anti-dumping authority website at http://commerce.nic.in/adfin_leadbat.htm

actions mainly concerned about imports from other countries, as happened in the acid battery case. The best strategy for reducing the likelihood that AD cases will be brought, and for minimising the damage if they are, is to follow low protection policies in the domestic market. By following its present protection policies with the almost automatic use of para-tariffs to provide very high protection levels (see section 4 below) Bangladesh is doing the opposite and increasing its vulnerability to AD actions in India and elsewhere, if these protected industries begin to export.

Export policies India operates an extremely comprehensive set of export policies which have been an outcome of many years of efforts to make remove or offset barriers and disincentives for exports that were an inevitable by-product of its import substitution policies.²⁵ Two aspects of these policies that are relevant for India's trading relationship with Bangladesh in the context of a bilateral FTA or SAFTA are the following:

- Rebates for exporters under duty neutralization schemes such as duty drawback and DEPB²⁶ have been substantially reduced during the past five years as tariff levels have declined. For example, DEPB rates for exported garments which were 16% during 2002/03 had been reduced to a range of between 3.2% and 8.5% in December 2004. As pointed out in the RMG case study, these reduced DEPB rates mean that Indian domestic prices of exportable garments (as well as of other exportables) are likely to be not far above fob export prices, and may be below cif prices, increasing the difficulty for Bangladesh RMG exporters to compete in the Indian market, even under an FTA. This reduces or even removes the standard 'uneven playing field' problem of an FTA on the Indian side i.e. the problem that FTAs will normally allow exporters to exempt or rebate import duties on inputs in the normal way, but that the exported products then compete without paying tariffs with producers in the partner country, which pay normal tariffs on their imported inputs.
- In recent years India has demonstrated that it is willing to subsidize its exports of rice when there have been large domestic surpluses. In some years India's exports were large relative to the narrow international market and probably reduced world prices, with resulting economic welfare benefits to Bangladesh as an importer. Bangladesh would need to think carefully about the economic costs and benefits of this if rice were to be included in an FTA with India. India has also been willing to subsidize wheat and sugar exports when there have been domestic surpluses, but in these cases the volumes have not been sufficient to have much impact on world prices, so this is less of a complication in thinking about these two sectors in the context of a bilateral FTA or SAFTA.

²⁵ An up-to-date outline of these policies is in the World Bank trade policy *Overview* report (vol II, Chapter 4)

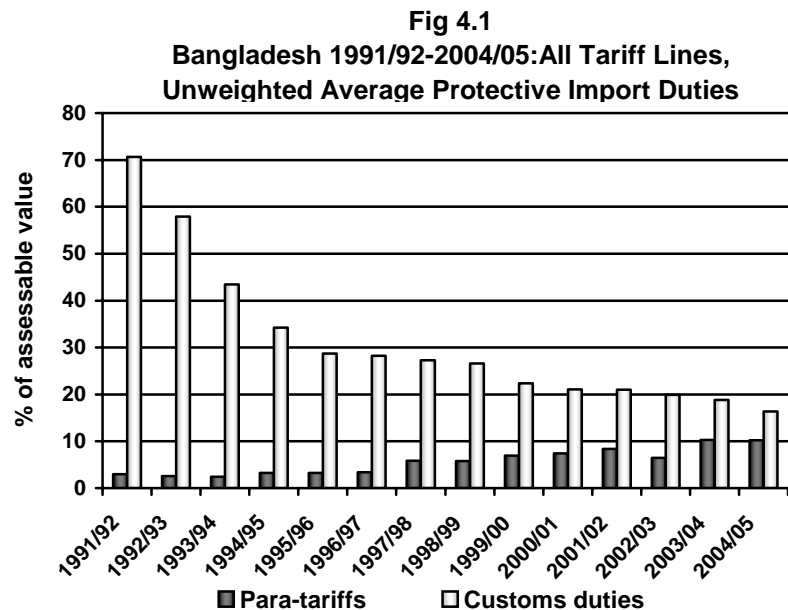
²⁶ Duty Exemption Pass Book. This system is described in the *Overview* report and in recent changes in DEPB rates for garments are given in the RMG industry case study (Table 6, p.15).

Chapter 4: Bangladesh's trade policies

There is a detailed description and analysis of Bangladesh's trade policies in the recent World Bank trade policy *Overview* report²⁷. This section summarises some of the main findings of that report that are relevant for the Bangladesh's trading relationship with India, and includes new information that is now available for 2004/05, especially on Bangladesh's para-tariffs which during 2004/05 continued to increase their role in Bangladesh's policies of protecting domestic producers from import competition. Various aspects of Bangladesh's import policies are considered first and at most length, since they would be most directly affected if there were an FTA between India and Bangladesh. This is followed by a brief discussion of some relevant aspects of export policies.

Non tariff barriers. During the late 1980s and early 1990s, most explicit QRs were abolished. Of the continuing restrictions the most important by far was the ban on textile fabric imports for use in the domestic market, which protected the textile industry. This was finally removed in January 2005. But there are still QRs on the import of chicks, eggs, salt and some packaging materials, and also on a few other products (e.g. mosquito insecticides) ostensibly for health, safety environmental and other grounds. Various permits, clearances and approvals are also required for extensive lists of other products, even though they are not formally subject to import licensing. In addition, the Bangladesh Bank requires that all imports be financed by an LC issued by an authorised bank in Bangladesh, and until December 2003 it required the importer to deposit a 30% cash margin. Moreover, in order to curb imports when the central bank thought the foreign exchange situation was weak, the margin was periodically increased for particular commodities. In the various studies undertaken as part of this project, except for sugar and textile fabrics, explicit QRs did not emerge as an impediment or special issue either for Indian exporters or in Bangladesh, possibly because the products still subject to QRs were not covered in the studies. Import procedures in Bangladesh and the resulting transaction costs for importers were also not covered explicitly, but they did come up in some of the work in India on transaction costs and the financing of Indian exports to Bangladesh. In particular the Bangladesh Bank LC rules and more generally the credibility of the Bangladesh banks were reported to constrain Indian exports to Bangladesh, and as one of the factors responsible for illegal practices in the border trade, especially at the Petrapole-Benapole border crossing.

An important general non-tariff constraint on Bangladesh's imports from India is the fact that only four out of the 42 Customs posts on the land border with India are allowed to clear all imported goods: the others are limited to dealing with a very short list of products and must obtain case-by-case authorization from the National Board of Revenue for clearing anything not on this list (see discussion below). In addition-ostensibly in the interests of limiting illegal imports- since July 2002 Bangladesh has required that two of its principal imports from India – sugar and textile yarns-can only be



²⁷ World Bank *Trade Policies in South Asia: an Overview*. Report no 29949, September 7, 2004. Three volumes.

imported through its sea ports. Restrictions on what land border Customs posts are allowed to handle also exist on the Indian side, as discussed previously in the section on India’s trade policies.

General tariff trends. During the first five years of the 1990s, up to 1995/96, Bangladesh’s tariffs were cut drastically (Table 4.1 and Figs 4.1, 4.2, and 4.3). The unweighted average protective rate of all tariff lines fell from 73.6% in 1991/92 to 32% in 1995/96. After 1995/96 this liberalizing impetus stalled, and during the following ten years up to 2004/05 tariffs declined only slightly. Average industrial tariffs came down modestly (by 6.4 percentage points from 31.9% to 25.4%) but the average protective rate for agriculture (including fisheries, livestock and processed foods)²⁸ was 32.7% in 2004/05, slightly higher

Fig 4.2
Bangladesh 1991/92-2004/05: Industrial Tariff Lines.
Unweighted Average Protective Import Duties

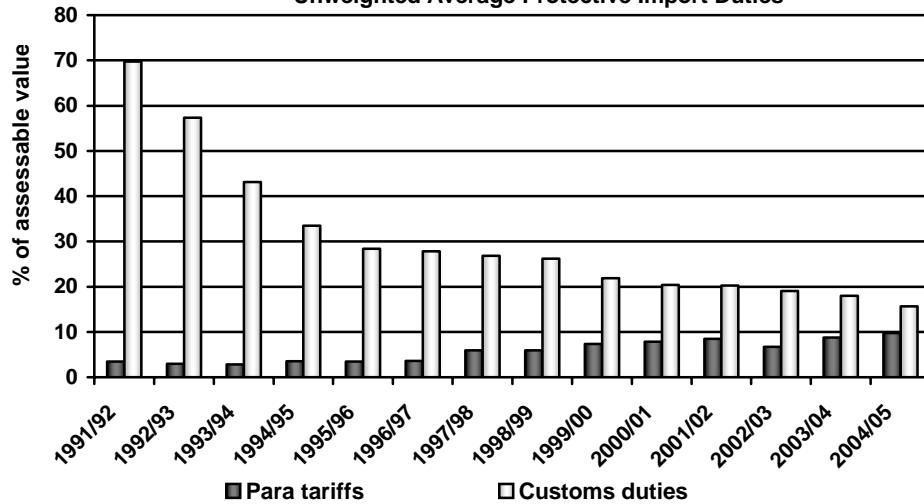
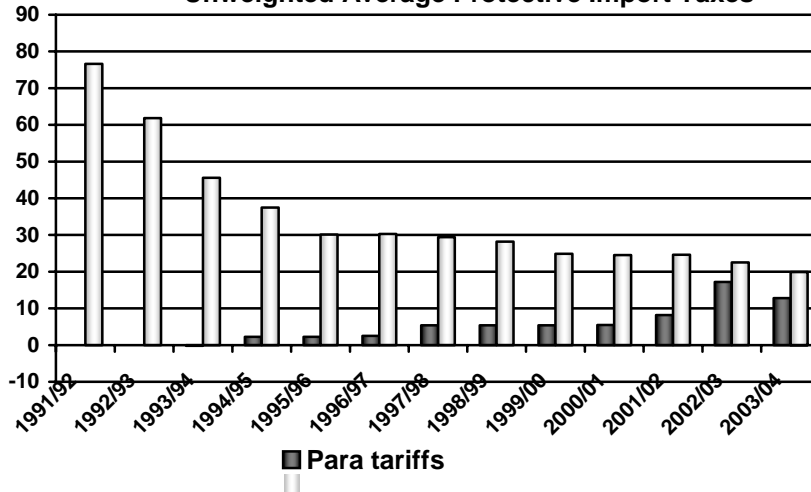


Fig 4.3
Bangladesh 1991/92-2004/05: Agriculture Tariff Lines.
Unweighted Average Protective Import Taxes



²⁸ HS 1-24. This definition of “agriculture” differs somewhat from the WTO definition of the sectors covered by the Agreement on Agriculture, mainly by including fisheries and marine products (HS 03) and excluding hides and skins and various natural textile fibres such as jute, cotton and wool.

than it had been 10 years earlier. In fiscal 2006/07, over all tariff lines, the unweighted average protective rate declined by 7.7 percentage points, from 32% in FY1995/96 to 24.3%.

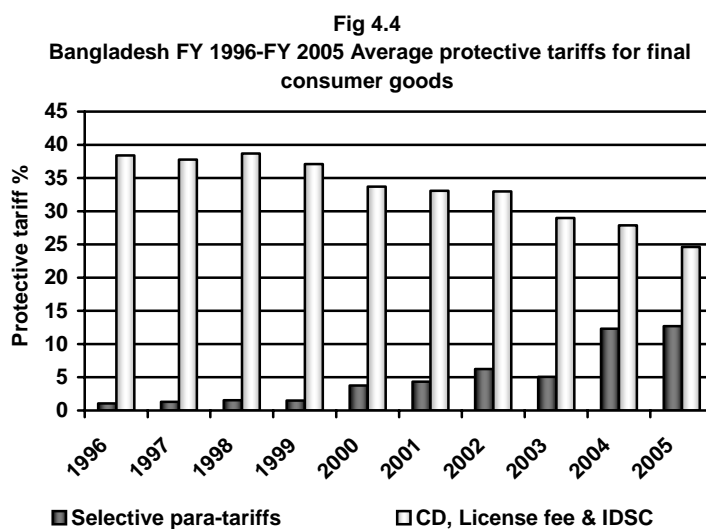
Para-tariffs This slowing of tariff reduction occurred because continuing cuts in Customs duties were offset by increases in the scope and levels of a variety of para-tariffs which were imposed on top of Customs duties. By 2004/05 (see Table 4.1) about 40% of the unweighted average protection level was due to para-tariffs, and para-tariffs were being applied to 21% of total tariff lines. How these para-tariffs interact with Customs duties and with each other and affect protection levels is complex. Formulas were developed as part of this and the earlier trade policy *Overview* report for estimating the resulting total protection rates for different combinations of para-tariffs. These are given in Annex I, together with some examples.²⁹

Five different para-tariffs have been used at different times since the early 1990s viz:

License fee (LF): from 1991/92 until it was discontinued in 2002/03, at a fixed rate on assessable value (AV). The assessable value of an imported good is usually the cif price +1%.

- *Regulatory duties (RD)*: from 2000/01 at varying rates on assessable value (AV) until discontinued in 2004/05.
- *Infrastructure Development Surcharge (IDSC)*: since 1997/98 to the present. Currently at the rate of 4% on assessable values
- *Supplementary duties (SD)*: since 1991/92 to the present: at varying rates on assessable values plus Customs duty. The rates generally used during 2004/05 were 15, 25, 30, 35, 60, and 90 percent. Imposed as was usually the case on top of a 25% Customs duty, these correspond to considerably bigger increases in the protection rate (e.g, a 15% supplementary duty increases protection by 18.8 percentage points, and a 90% supplementary duty increases protection by 112.5%).

Protective VAT: since 1991/92 to the present. This is the practice of imposing the normal 15% VAT on an imported product but exempting the same product from VAT when it is produced domestically. The base for the VAT on imports is (AV+CD+RD+SD)-it does not include the IDSC. Whether the exemption of the domestically produced product actually provides extra protection depends on whether the subsequent buyer is also subject to VAT and loses the normal VAT credit. As discussed in the World Bank trade policy *Overview* report, this technique has generally been used for final or near final stage consumer goods and provides



²⁹ When starting this study we did not find any conceptually sound methods for measuring the combined protective rate of Customs duties and the para-tariffs, either at NBR or elsewhere in writings and research on Bangladesh's trade policies. Perhaps for this reason, there is no discussion or recognition in Bangladesh either in official publications or elsewhere, of the total protection rates resulting from the tariff system. Most discussions just mention the Customs duties, but this is meaningless without taking account of the para-tariffs. Elucidating and publicising the protection rates resulting from Customs duties and para-tariffs would appear to be a straightforward and obvious task for the National Board of Revenue or the Tariff Commission.

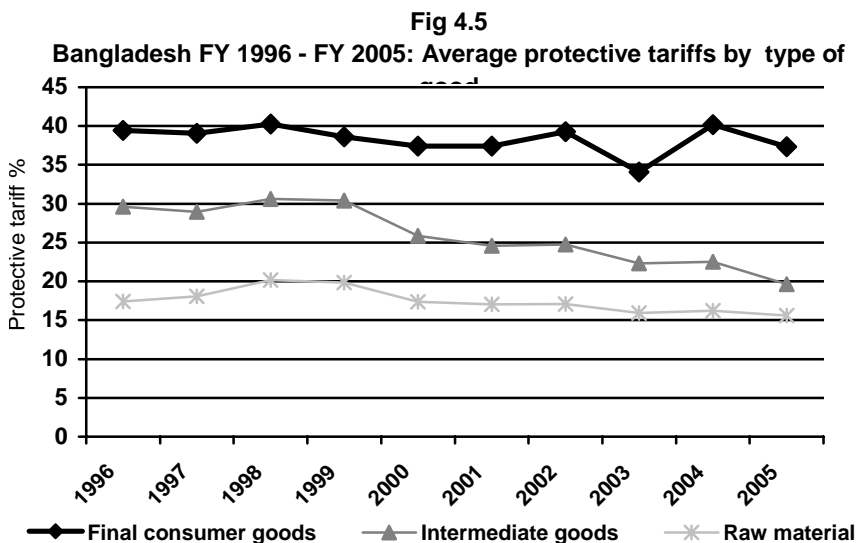
extra protection since the VAT system in Bangladesh does not effectively extend to wholesale and retail distribution.³⁰

In addition importers have to pay a tax called *advance income tax (AIT)* This is charged on nearly all imports at 3% of assessable value, and can be credited against the importer’s income tax liability. For this reason in principle it is not a protective tax, insofar as the domestic producers of the product are also subject to income taxes. For this reason it has not been considered a protective tax in this study, but if income taxes are not imposed or not collected on domestic production, it would operate as another protective para-tariff.

During the first part of the period covered by the India-Bangladesh trade study, the last four of the protective para-tariffs listed above were in force, and since July 2004 when the regulatory duties were discontinued, the last three have been in force. The IDSC for the most part is an across-the-board import tax at a flat rate from which relatively few imported products are exempt. During FY 04 and 05 the rate was 4%, so the effect in most cases is just to increase the Customs duty by this amount. In 2004/05 this means that the four standard Customs duty “slabs” of 25, 15, 7.5 and 0 percent are in practice 29, 19, 11.5 and 4 percent, and the distortionary effects resulting from the dispersion of the four Customs duty rates is actually slightly reduced.³¹

By contrast, the three other para-tariffs have been used selectively to provide very high protection levels to a wide range of import substitution industries, in some cases to intermediate manufactured products, but in the vast majority of cases to protect domestically produced final consumer goods. The deployment of the selective para-tariffs has been growing especially rapidly, albeit somewhat erratically, since 1998/99. In 2004/05 about a fifth (21.07%) of all tariff lines (1405 out of a total of 6667 lines) were subject to either a supplementary duty, a protective VAT, or both (Table 4.2)³². In 2003/04 there was a sudden spurt in the use of regulatory duties, with the number of products subject to them jumping from 35 to 334, but for unknown reasons they were all cancelled in the 2004/05 budget (Table 4.3). However this change was more than offset by a big expansion (a 55% increase) in the number of products subject to supplementary duties. Consequently both the absolute number of tariff lines and subject to one or more para-tariff, and the proportion of total tariff lines subject to para-tariffs, once again increased in this year.

The concentration of extra para-tariff protection in consumer goods is apparent from Table 4.4, which shows unweighted average total protection rates distinguishing basic raw materials, intermediate goods, capital goods and final consumer goods over the 10 years since 1995/96. In 2004/05, without the selective para-tariffs, the maximum normal protection



³⁰ See especially the discussion in the appendix (p. 69) of Volume III.

³¹ It is increased in relation to unsubsidized exports, however.

³² The tariff lines referred to here are Bangladesh’s 8-digit HS classification of MFN tariffs i.e. leaving out special discounted tariffs for specified “end users” and preferential tariffs (for example under SAPTA)

resulting from the maximum Customs duty (25%) and the IDSC tax (4%) and with VAT applied to both imports and the domestic product, was 28.5%.³³ But in 2004/05 the average final consumer good protection rate was 37.3%, reflecting the effect of the selective para-tariffs. Also, during the 10 years since 1995/96 there has been no downward trend in this protection rate (Figs 4.4 and 4.5) despite reductions in Customs duty rates during the period and the discontinuance of the license fee in 2002/03. By contrast the average protection rates on basic raw materials, intermediate goods and capital goods are much lower, and in the case of raw materials and intermediate goods have been trending down since 1998/99 (Fig 4.5). The downward trend in intermediate good tariffs is especially marked, and suggests the existence of a consistent policy which seems to have started in about 1998/99, of increasing the protection to the processing margins of import competing industries selling in the domestic market, by pushing up the tariffs protecting their outputs while reducing the tariffs on their intermediate inputs. One of the key reasons for these much lower protection levels and divergent trends during the five years is the much lower incidence of the selective para-tariffs among raw materials and intermediate goods, and to a lesser extent capital goods (Table 4.3). Thus, in 2004/05 the selective para-tariffs added 12.75 percentage points to the average protection of final consumer goods, but only 0.87, 1.30. and 3.06 percentage points respectively to the average protection of raw materials, intermediate goods and capital goods.

So far the effects of the para-tariffs on average protection levels have been discussed, but the essential feature of these instruments is that they are selective and flexible and provide wide discretion in deciding the level of protection to be afforded to particular products and the firms and industries that produce them. For example, the government can decide whether to impose a 15%, a 35% or a 90% supplementary duty on top of a normal Customs duty, whether or not to provide a domestic VAT exemption, or perhaps to provide a combination of both. In this way the para-tariffs directly contradict and appear to have largely undermined a number of key objectives of the 1990s tariff reforms, which were to cut tariffs and make them more uniform, reduce their complexity by cutting the number of Customs duty slabs, and in these ways to also reduce the scope for discretion in decisions on protection levels.

Some indication of the selective use of the para-tariffs to provide high protection levels is given Table 4.5. This reproduces the total protection rates in 1997/98 and 2003/04 for a sample of 55 products and product groups analysed in the World Bank trade policy overview report³⁴ and adds the total protection rates in 2004/05 for the same products. For most industries producing this group of products, there has been a massive increase in tariff protection during the years since 1997/98, even though protection rates were high to start with. Between 1997/98 and 2003/04 the simple average protection rate for the group of products went up by approximately 24 percentage points, from 50.8% to 74.7%. It increased for 50 of the 55 products, in most cases very substantially e.g. processed seafood from 35% to 88%, milk powder from 47% to 62%, sugar from 47% to 85%, sweet biscuits from 47% to 131%, cement from 25% to 66%, soaps and detergents from 61% to 98%, plastic tableware from 51% to 91%, textile fabrics from 65% to 72%, glass and glass products from 47% to 85%. For only five of the products did the total protection rate decline, and this reduction was minimal and from already high levels e.g. the salt protection rate fell from 150.8% to 143.2%, and the protection rate for after shave preparations fell from 64.6% to 54.6%. During 2004/05, the total protection rates of most of the products in this group fell, but the majority remained considerably higher than they had been in 1997/98. The average protection rate of the group declined to the still very high level of 66%, with protection rates of individual products and product groups ranging from 47.2% to 141%.

³³ Because the base for the import VAT does not include the IDSC tax, whereas the base for VAT paid by a domestic producer is the ex-factory price, the effect of the VAT is to slightly reduce the total protection rate, in this case by about 0.52 percentage points.

³⁴ Op cit , Vol II, Table 3.15

“End user” tariff concessions. As well using the para-tariffs to raise the protection for the outputs of domestic industries, the government has developed a system of special “end user” tariffs which provide low concessional tariffs on the inputs and capital equipment for specified industries or for specified uses. In 2004/05, corresponding to the 6667 MFN tariff lines, there were 2503 “end user” concessional tariffs (Table 4.6), often more than one for the same product. These concessional tariffs are much lower than normal MFN tariffs, and in the case of machinery and parts used by exporters, the concessional protective tariff is zero. On average the “end user” tariff was 7.4%, and 10.5% if the zero machinery and part tariffs for exporters are excluded. This compares with the average MFN protective rate of 26.6% and with the following protective structure if only the four normal Customs duties and IDSC tax are imposed:

As indicated in Table 4.6, there are only two major industries which receive special end-user concessions for their intermediate materials, namely the pharmaceutical industry and the insecticide industry. Bangladesh has well developed systems (mainly export processing zones and bonded warehouses) for providing duty free intermediate materials for its export firms, and this is not handled as part of the “end user” concessional tariff system. Hence, except for these two industries, the end user concessions do not appear to be systematically used to increase the effective protection (processing margins) of import substitution industries. Instead, this is generally done by applying the lower standard Customs duty rates to inputs and adding para-tariffs to the protection for final products. For example, the HS chapter covering plastics and plastic products includes the following protective tariffs:

<i>Customs duty %</i>	<i>Protective rate %</i>
0	3.48
7.5	10.98
15	18.48
25	28.48

<i>HS code</i>		<i>2004/05 protection rate %</i>
3924.10.00	Plastic tableware & kitchenware	83.7
3924.90.90	Household toilet articles of plastic	83.7
3922.10.00	Baths, showers, sinks, washbasins of plastic	59.7
3922.20.00	Lavatory seats and covers	59.7
3922.90.00	Toilet systems of plastic	59.7
3918.10.00	Floor coverings of PVC	47.2
3918.10.00	Floor coverings of other plastics	47.2
3919	Plastic adhesive rolls and foil	47.2
3920	Plate, sheet, film of plastic-other	47.2
3901-3914	Plastic polymers in primary form (PVC, polyethylene, polystyrene etc)	18.5

The high protection rates for the final products on this list (and for other final plastic products not shown here) are due to supplementary duties (applied to 35 products in this chapter) and the use of the protective VAT in combination with a supplementary duty in the case of tableware, kitchenware and household toilet articles. Para-tariffs are not applied to the intermediate plastic polymers which are just subject to the 15% Customs duty and the 4% IDSC. The protection rate for a variety of other final plastic products (presumably not yet produced in Bangladesh?) is generally 28.5%. Similar patterns of tariff escalation are found both within and between other HS tariff chapters: for example the average MFN tariff for iron and steel (HS 71) is 13.6% while the average protective tariff for iron and steel products is 30%, and closer investigation of these two product groups and others will almost always reveal cases of much steeper tariff escalation, where para-tariffs have been applied to finished products.

The end user concessions are more important for machinery and equipment, where the protective tariff for machinery and parts used by firms selling in the domestic market is 7.5% and zero for the same machinery and parts if they are used by “100% export oriented” firms. Most users of machinery in Bangladesh probably benefit from these concessions since the 7.5% “capital machinery” concession for non-exporters applies to about 40% of the tariff lines in the two principal HS chapters covering non-

electrical and electrical machinery (HS 84 and HS 85). Without these concessions many machines would cost more, since the same standard MFN tariff structure applies to them as shown above for plastic products i.e. Customs duties of zero, 7.5%, 15% or 25% corresponding to protection rates of 3.48%, 10.98%, 18.48% and 28.48%. But the concession is not available unless the machines are used as capital equipment to produce something else, and a close look at these chapters reveals a number of products- mostly durable consumer goods probably being produced domestically-with very high protection rates. For example:

<i>HS code</i>		<i>2004/05 protective rate %</i>
8415.1010	Domestic air conditioners <3 bhp	72.2
8607 & 8609	Engines for three wheelers, 4 stroke	72.2
8414.5110	Domestic room fans	59.7
8413.20	Hand air pumps	47.8
8414.20	Hand & foot operated air pumps	47.8
841810	Domestic refrigerators	47.2

These examples suggest that the government is willing to provide high protection to local machinery production when final consumers are the users, but that it prefers low tariffs for industrial machines -e.g. the 3.7% or 7.5% tariffs on textile machinery- in part probably because of the lobbying power of industrial users. In any case these very large differences certainly contribute to a very distorted protection structure in the machinery sector, with negative or very low effective protection rates for most industrial machines and extremely high effective protection rates for a number of consumer durables and perhaps some other machines³⁵. The low tariffs on industrial machines also increase the effective incentives of products they help to produce that are sold domestically, but on the other hand the anti-export bias of the incentive system is somewhat lower than it otherwise would be if exporters did not receive this concession.

Agriculture, livestock, fisheries and processed food. Bangladesh's trade policies in these sectors warrant separate treatment because, as in India, they differ in important ways from its manufacturing trade policies, in addition to which Indian agricultural products are generally a large although fluctuating share of its total exports to Bangladesh³⁶. Understanding "low" tariffs as 10-15% or below, "moderate" as 15-25%, "high" as 25-40%, and very high as exceeding 40%, these policies can be characterised as follows:

- Relative to other products, low tariffs and other incentives (no large input subsidies) for the major food grain crops -- rice, coarse grains, wheat, and pulses. Together, these account for by far the largest part of agricultural GDP and agricultural employment. They are economically efficient, low cost industries, and trade policies have been managed to keep consumer prices down by allowing imports-most of which come from India- over quite low tariffs (around 10%) during periods when domestic production has lagged behind demand.
- Very high tariffs on frozen shrimp and fish, and quite high tariffs on tea and raw jute, despite the fact that these are all major exports and that competition between exporting producers would be expected to keep domestic prices broadly in line with export prices.

³⁵ Tariffs on steel and other machinery inputs (e.g. steel, metals, electronic components) are higher than industrial machinery tariffs (zero for machinery used by exporters and up to 7.5% for most domestic market users), so effective protection for local production of these machines and also for replacement parts is probably negative in most cases. By contrast consumer durable tariffs are much higher than the tariffs on most of the inputs that are used to produce them, so the firms that produce them in Bangladesh have extremely high effective protection to their processing margins.

³⁶ For more detail on Bangladesh's trade policies with regard to these products see the trade policy *Overview* report (volume III, Chapter 1, pp 16-18).

- Except for coconut oil, low or moderate tariffs protecting import competing oilseed farmers and edible oil producers. Very high tariffs protecting the sugar industry and a number of other import substitution crops, in particular some vegetables, fruits, nuts, and spices.
- In the livestock sector, high to very high protection for dairy products and the poultry industry, but low for cattle herding as a result of an export ban on live cattle, skins and partially processed leather.

High or very high tariffs protecting import substitution food processing industries, as is apparent from the following unweighted average protective tariffs for the HS processed food chapters:

<i>HS chapter</i>	<i>Products included</i>	<i>Average protection rate 2004/05 %</i>
04	Dairy products, eggs, honey etc	45.3
15	Animal & vegetable fats and oils etc	33.1
16	Preparations of meat, fish, crustaceans etc	30.2
17	Sugar and sugar confectionery	39.5
18	Cocoa and cocoa preparations	41.1
19	Preparations of cereals, starch or milk; pastry cook products	44.8
20	Preparations of vegetables, fruits, nuts, etc	42.2
21	Miscellaneous edible preparations	32.9
	Average of 8 HS processed food chapters	38.6

As with the rest of manufacturing, protection rates for the processed food industries have been kept up by the widespread use of the selective para-tariffs; otherwise the maximum protection rate in 2004/05 would have been 28.5%. Like other sectors, the averages also conceal large variations in protection rates within individual chapters, with exceptionally high protection rates for some products that have received special treatment, and much lower for others.

The high protection rates for some of the agricultural and other primary products, but especially of processed foods, from the viewpoint of Bangladesh consumers constitute a substantial and highly regressive indirect tax. This has important implications for the likely economic effects of an FTA with India, because if Bangladesh were to import these products duty free there could be large economic welfare benefits for Bangladesh consumers, but also difficult adjustment problems for the Bangladesh producers that lose protection. How the resulting economic costs and benefits might work out is discussed in a project case study paper using the example of the sugar industry. By contrast, it is probable that not much would change for Bangladesh consumers or for producers, if rice and Bangladesh's other cereal crops were included in an India-Bangladesh FTA, because of the Bangladesh protection levels that are already quite low.

Bangladesh's tariff preferences for India. Bangladesh gives tariff preferences to imports from India under the Bangkok Agreement and under SAPTA.³⁷ The current members of the Bangkok agreement are India, Bangladesh, Sri Lanka, Republic of Korea, Laos and China (China joined in 2001). However, the Bangladesh tariff schedule's list of tariff preferences only mentions India, Sri Lanka and South Korea. In FY 05 in Bangladesh only 132 tariff lines (out of a total of 6667) were subject to preferences under this agreement, the general preference rate was only 10% of Customs duties, and preferences did not apply to para-tariffs. Consequently the tariff advantages accorded were negligible. For example, after allowing for para-tariffs, the preferential total protective rate for car engines > 2600 cc³⁸ was 25.98% versus a general MFN rate of 28.48%, and the preferential rate for peppers³⁹ was 66.01%

³⁷ For more on the Bangkok Agreement and SAPTA, see the World Bank trade policy *Overview* report, volume II chapter 5.

³⁸ HS 84082030

³⁹ HS 04091120

versus a general MFN rate of 69.31%. Under SAPTA, Bangladesh gives preferences on 561 tariff lines to India as one of the three more developed SAARC countries (the others are Pakistan and Sri Lanka). However, the preferences are once again only 10% of Customs duties and do not apply to para-tariffs, so the margins of preference are negligible. For example in FY05 the preferential total protective rate for India on processed meats⁴⁰ (in “wrapped/canned” form) was 44.88% versus 47.75% on meat from non-preferential sources. For raw materials and intermediate inputs where Bangladesh’s protection rates are generally very low, the SAPTA preference margins are also extremely small and in a number of cases where the Customs duty has been cut to zero, the preference margin is also zero e.g. both the preferential and the MFN total protective rates of a number of mineral ores⁴¹ are 3.48%. Overall, the tariff preferences Bangladesh has given to India (and to the other member countries) under both the Bangkok Agreement and SAPTA are purely symbolic: their main effect has been to further increase the complexity of the tariff schedule and Customs administration rather than to provide any substantive preferences for imports from India of any of the other Bangkok Agreement or SAPTA countries. In studies and surveys done as part of the India-Bangladesh trade project, they were never mentioned and for all practical purposes can be ignored.

Customs clearance at land border Customs posts Actual or prospective Indian exports to Bangladesh in principle are subject to the same Customs clearance as rules any other exports if they go by sea to the main Bangladesh sea ports (i.e. Chittagong & Mongla) or by air, and similarly Bangladesh exports to India that are sent through India’s principal sea ports or by sea or air are also subject to the same Customs clearance rules as other exports to India. But for exports originating in the Indian states near the land border, land and/or river transport over the land border is frequently the most direct and least expensive route, especially if the market for the goods is in the nearby border areas of Bangladesh, and for trade between the north-east and eastern Indian states and Bangladesh the land border is the *only* feasible route. But the land border trade is subject to very serious administrative constraints in Bangladesh, because 38 out of the 42 land border Customs posts with India severely restrict the imported goods that can be cleared, and only four land border posts can clear all imported goods. In terms of volume the most important by far of the Customs posts with comprehensive Customs clearance powers is at Benapole, which borders Petrapole on the Indian side and which is on main roads linking Kolkata with Jessore and Dhaka. Two others are at Hili and Shonamosjid on the north west border with West Bengal, and the fourth at Tamabil in the far north east, on the border with Meghalaya. Of the others, 36 Customs posts can only deal with 17 specified (mostly agricultural) products,⁴² and to clear other products special permission has to be obtained from the National Board of Revenue. Two other Customs posts are restricted to clearing products included in a different small list.

In addition to these general constraints on imports by the land border, both Bangladesh and India have periodically constrained imports of certain products by specifying the ports at which they can be cleared by Customs. Bangladesh did this in July 2002, when it imposed a ban (still in force) on the import of sugar and textile yarns through any of its land ports-including and especially Benapole- and required all imports to come by sea. These are consistently two of the principal products which Bangladesh imports from India, and the ostensible reason was to reduce “official” smuggling with the connivance of Customs, which was alleged to be particularly prevalent at the Petrapole-Benapole crossing.⁴³

⁴⁰ Most meats in HS chapter 02

⁴¹ Mineral ores, ash etc in HS 26 e.g. HS 26264000 (ash and residues containing aluminium)

⁴² Livestock, fish-pona, fresh fruits, seeds, rice, wheat, stone & boulders, coal, chemical fertilisers, china clay, timber, lime stone, onions, garlic, ginger, ball-clay, quartz

⁴³ These measures are discussed in the project case studies on sugar and ready made garments (pp 28 and 34 respectively)

As noted in the previous discussion of India's trade policies, from time to time India has also placed limits on the imports from neighbouring countries that can be cleared at its land border Customs posts, but in June 2005 it seems that this "port notification instrument" was not deliberately being used as a way of restricting imports from Bangladesh.⁴⁴ More important, India restricts the ports which can administer its various export incentives, and in June 2005 it was reported that DEPB-which is the most widely used-was not available at any of the land border Customs posts with Bangladesh except at Petrapole, resulting in the diversion of Indian exports to Bangladesh, to this crossing⁴⁵. In Bangladesh, however, it seems that there are no limits on the exports that can be cleared by Customs at its land border Customs posts.

Potential exports from India to Bangladesh that are not eligible to be cleared by Bangladesh Customs at a nearby border crossing will be often faced with the alternative of either transporting the goods –perhaps a thousand kilometres or more- to the Petrapole crossing or one of the other three unrestricted crossing places, or to a distant port such as Haldia for shipment by sea. For the north east and eastern Indian states, these alternatives will often be prohibitively costly, so the restrictions amount to a ban on exports from these states to the nearby regions of Bangladesh, in products that are not listed. This in turn provides a strong incentive to send the goods illegally, either by "bootleg" smuggling which bypasses the Customs posts altogether, or by "official" smuggling involving bribes to Customs and other officials on both sides of the border (see the section below on informal trade).

There are a number of obvious reasons for the limits on the products that can be cleared at land border Customs posts. It is principally a legacy of the long period of highly restrictive import policies followed by both countries in the past, involving pervasive QRs of all kinds and prohibitively high tariffs which discriminated above all against trade between each other and with other developing countries, much more than against trade with developed countries. The consequent low volumes of legal trade meant that there was no, or very little, need to incur the expense of installing capacity for Customs clearance at large numbers of small border Customs posts, or to even establish Customs posts at all at many border crossings. For example, India's *de facto* ban on the import of all consumer goods (including agricultural products and textiles) which was only finally phased out in April 2001, meant that there was no point in maintaining the capacity for clearing imports of these goods, except at major ports to handle exceptional cases. A further consequence was that there was also no point in building transport and storage and other infrastructure at these places, since the volume of legal trade that was feasible trade did not justify it.

Export policies Bangladesh's exports are dominated by ready made garments, most of which are exported to the US and the EU. Nearly all garment exports are from firms operating in export processing zones or as bonded warehouses. In both cases they can import their textile and other inputs free of Customs duties and all other import taxes (including the 3% advance income tax) with the use of "back-to-back LCs" i.e. letters of credit based on LCs issued for their exports. As noted previously, machinery used by exporters is also exempt from all import taxes under the "capital machinery" provision for exporters. Until June 2005 there was also an arrangement which paid subsidies on domestic fabrics used by garment exporters. Apart from these, there is a standard array of duty neutralization schemes (e.g. duty drawback) and export incentives (e.g. preferential export credit) and export promotion institutions and activities of the kind used in many developing countries (see the trade policy *Overview* report for a summary). In addition, however, there are a number of non-standard export policies which would need to be discussed with India in the context of bilateral FTA, or with the India and the other South Asian countries in the context of SAFTA. These combine export bans and restrictions on a number of

⁴⁴ Personal communication from Arun Goyal, June 3 2005.

⁴⁵ Ibid

unprocessed or partially processed primary products⁴⁶, and export subsidies when some of these products are exported in processed form. The intention of these measures is to make processed exports more profitable by increasing gross margins by lowering the prices of the raw materials and increasing the return from the exported finished products, but both measures contravene WTO rules and the Agreement on Agriculture in particular. They are also likely to run into trouble if used to promote exports to India or to one of the other South Asian countries as part of a free trade agreement.

Table 4.1: Bangladesh 1991/92-2004/05: Unweighted Average Protective Import Duty Rates

	All tariff lines			Industrial tariff lines			Agriculture tariff lines		
	Customs duties	Para-tariffs	Total prot rate	Customs duties	Para-tariffs	Total prot rate	Customs duties	Para-tariffs	Total prot rate
1991/92	70.64	2.98	73.62	69.72	3.44	73.16	76.64	-0.01	76.63
1992/93	57.93	2.59	60.52	57.34	2.99	60.33	61.83	-0.03	61.80
1993/94	43.47	2.43	45.90	43.13	2.84	45.97	45.58	-0.17	45.41
1994/95	34.24	3.30	37.55	33.52	3.54	37.06	37.49	2.23	39.72
1995/96	28.70	3.26	31.96	28.40	3.47	31.87	30.07	2.28	32.36
1996/97	28.24	3.38	31.61	27.79	3.58	31.37	30.25	2.48	32.73
1997/98	27.27	5.88	33.15	26.80	5.98	32.78	29.42	5.42	34.83
1999/99	26.59	5.82	32.41	26.23	5.92	32.15	28.19	5.37	33.56
1999/2000	22.40	6.99	29.39	21.86	7.33	29.19	24.87	5.41	30.28
2000/01	21.10	7.43	28.54	20.39	7.84	28.23	24.53	5.46	30.00
2001/02	21.02	8.41	29.43	20.28	8.47	28.75	24.60	8.15	32.74
2002/03	19.91	6.51	26.42	19.08	6.74	25.82	23.85	5.44	29.29
2003/04	18.82	10.29	29.11	18.02	8.81	26.82	22.56	17.22	39.77
2004/05	16.39	10.23	26.62	15.67	9.76	25.43	19.89	12.81	32.70

Table 4.2: Bangladesh 2003/04 and 2004/05: Distribution of tariff lines with extra protection above Customs duties plus IDSC tax, provided by VAT exemptions, supplementary duties and regulatory duties

Extra protection from	2003/04		2004/05	
	No of tariff lines	Percent of total lines	No of tariff lines	Percent of total lines
VAT only	372	5.41	339	5.08
SD only	389	5.66	823	12.34
RD only	145	2.11	0	0.00
VAT+SD	233	3.39	243	3.64
VAT+RD	122	1.77	0	0.00
SD+RD	67	0.97	0	0.00
Subtotal	1328	19.31	1405	21.07
No extra protection	5549	80.69	5262	78.93
Total lines	6877	100.00	6667	100.00

IDSC=Infrastructure Development Surcharge; VAT=Value added tax; SD=Supplementary duty;RD=Regulatory duty. Source: World Bank staff estimates from NBR database

⁴⁶ Raw hides, wet blue leather, and unfrozen and unprocessed prawns and shrimps are among the banned exports. A complete list of banned and restricted exports is given in the trade policy *Overview* report (see Vol III, Table 1.6 p 24).

Table 4.3: Number of tariff lines subject to selective paratariffs FY 03-FY 05

	2002/03	2003/04	2004/05
<u>Number of tariff lines</u>			
With protective supplementary duties	356	691	1066
With protective VAT	442	727	582
With regulatory duties	35	334	0
<u>Change from previous year</u>			
Protective supplementary duties		+335	+375
Protective VAT		+285	-145
Regulatory duties		+299	-334

Table 4.4: Unweighted average total protection rates by type of product (% of assessable values)

FY	Basic raw materials	Intermediate goods	Capital goods	Final consumer goods	All goods
1996	17.4	29.6	23.0	39.4	31.9
1997	18.1	28.9	23.2	39.1	31.6
1998	20.2	30.6	25.2	40.2	33.1
1999	19.9	30.4	25.4	38.6	32.4
2000	17.4	25.9	19.4	37.5	29.4
2001	17.0	24.6	17.7	37.4	28.5
2002	17.1	24.8	18.0	39.3	29.4
2003	15.9	22.3	18.7	34.1	26.4
2004	16.2	22.5	19.2	40.2	29.1
2005	15.6	19.6	18.1	37.3	26.5

Notes: Calculated from NBR database. The tariff lines averaged are MFN rates only: the averages do not include many "end user" tariff reductions, including tariff exemptions for end users who are exporters. The averages for intermediate and capital goods are considerably lower than shown here if these "end user" tariff reductions are averaged with the general MFN rates. The product definitions are adapted from the World Bank SINTIA protection software

Table 4.5: Bangladesh FY 1998, FY 2004 and FY 2005: some examples of total protection rates resulting from selective paratariffs on top of Customs duties, the license fee and the IDSC

HS code	Product or product group	Total protection rates			Change FY 98 to FY 04	Change FY 04 to FY 05
		FY 1998	FY 2004	FY 2005		
0302	Fish, fresh	35.0	64.0	32.0	29.0	-32.0
0302	Fish, wrapped/canned	35.0	88.0	50.8	53.0	-37.3
0402	Milk Powder	47.2	61.9	86.7	14.8	24.8
0405-0406	Dairy Products	68.9	90.9	86.7	22.0	-4.2
0805, 0806, 0808	Fruits: oranges, grapes, apples (fresh)	47.5	86.0	86.7	38.5	0.7
0906, 0907	Cinnamon, cloves	46.9	66.5	63.3	19.6	-3.3
1701	Cane sugar	34.7	98.4	73.2	63.7	-25.1
1704, 1806	Sugar confectionery	47.2	85.5	137.0	38.3	51.5
1905	Bakery products (sweet biscuits etc)	47.2	131.0	137.0	83.8	6.0
2007, 2009 & 2103	Food Preparation (Juice, Jam, Jelly, Tomato-ketchup etc)	47.2	85.5	86.7	38.3	1.2
220210	Soft drinks	46.0	68.6	56.7	22.6	-12.0
2501	Salt	150.8	143.2	141.0	-7.6	-2.2
25232910	Portland Cement	25.4	66.0	72.2	40.6	6.3
3208-3210	Paint & Varnish	47.2	66.0	59.7	18.8	-6.3
33,033,307	Perfumes	68.5	98.5	72.7	29.9	-25.8
3304-3305	Cosmetics	64.6	65.4	43.5	0.8	-21.9
3305	Shampoos	64.6	65.4	56.6	0.8	-8.8
3306	Toothpaste	47.2	98.5	72.2	51.3	-26.3
3307	After Shave preparation	64.6	58.8	72.2	-5.8	13.5
3401	Soap & detergent	61.4	98.5	72.2	37.1	-26.3
3605	Safety Matches	54.3	53.0	47.2	-1.3	-5.8
3919-3921	Sheet Polythene	47.2	53.0	47.2	5.8	-5.8
3922	Plastic Sanitary-ware	47.2	66.0	59.7	18.8	-6.3
3924	Plastic Table & Kitchenware	54.6	90.9	83.7	36.3	-7.2
4410-4412	Ply wood & particle board	47.2	53.0	47.2	5.8	-5.8
5208-5212, 5407-5408 & 5512-5516	Textile Fabrics	64.8	71.6	69.3	6.8	-2.3
5701-5705	Jute Carpet	47.2	75.9	83.7	28.8	7.8
5701-5705	Other Carpet	47.2	53.0	59.7	5.8	6.8
610910, 620342, 620520	RMG Products: cotton shirts, trousers & T-shirts	47.2	85.5	47.2	38.3	-38.3
6302	Cotton sheets	47.2	85.5	47.2	38.3	-38.3
6402-6404	Sports Footwear	54.3	53.0	47.2	-1.3	-5.8
6402-6405	Other Footwear	54.3	66.0	59.7	11.7	-6.3
6802	Ceramic Tiles: Other	47.2	61.3	49.8	14.1	-11.5
6904-6906	Ceramic Bricks, Blocks, Roofing Tiles etc.	47.2	53.0	47.2	5.8	-5.8
6907-6908	Ceramic Tiles: Glazed/Unglazed	47.2	54.6	64.0	7.4	9.5
6910	Ceramic Sanitary ware	47.2	89.0	64.0	41.9	-25.0
6911-6912	Ceramic Tableware & Kitchenware	47.2	98.5	72.7	51.3	-25.8
7003-7005, 7009, 7013	Glass & Glass Products	47.2	85.5	72.7	38.3	-12.8
7304, 7306	Iron & Steel Pipe: Other	47.2	53.0	47.2	5.8	-5.8
7306	Iron & Steel Pipe: ERW pipe	47.2	85.5	59.7	38.3	-25.8
7324, 7418	Iron, Steel & Copper Sanitary-ware	47.2	85.5	72.2	38.3	-13.3
821210	Razor	47.2	53.0	47.2	5.8	-5.8
8301	Lock	47.2	53.0	47.2	5.8	-5.8
8414	Electric Fan	47.2	66.0	59.7	18.8	-6.3
85061020	Dry Cell Battery	47.2	85.5	72.2	38.3	-13.3
850710	Lead acid Battery	47.2	85.5	72.2	38.3	-13.3
8527	Radio & Cassette player	47.0	58.7	47.2	11.8	-11.5
85281290	Colour TV	47.1	53.7	47.2	6.7	-6.5
853929	Light bulbs	54.3	66.0	47.2	11.7	-18.8
8539	Fluorescent lamps	54.3	53.0	47.2	-1.3	-5.8
85441920	Electric cables: Co-axial cable	47.2	66.0	59.7	18.8	-6.3
8544	Electric cables: Other	47.2	85.5	59.7	38.3	-25.8
8712	Bicycle & other Cycle	34.7	85.5	47.2	50.8	-38.3
9403	Furniture	47.2	53.0	59.7	5.8	6.8
9501-9503	Toys	47.2	85.5	72.2	38.3	-13.3
Average		50.8	74.7	65.4	23.9	-9.3

Table 4.6: Bangladesh tariff schedule 2004/05: Tariff lines with "end user" tariff concessions

Concession code	End use category	No of tariff lines	Average protective rate %
10	General exemption	9	4.0
11	General exemption, under certain conditions	31	10.1
15	General exemption, within a period	2	3.5
20	Capital machinery	505	7.5
21	Capital machinery, parts	231	7.5
25	Machinery textile industry (Table-1)	24	3.7
26	Machinery textile industry (Table-2)	41	7.5
30	Capital machinery, 100% export oriented	505	0.0
31	Capital machinery (parts), 100% export oriented	231	0.0
45	Parts for manufacturing solar panels	13	4.0
50	Raw materials for insecticides: Annex 1	56	4.1
51	Raw materials for insecticides: Annex 2	83	20.2
5A to 5K	Poultry sector (feeding systems etc)	72	3.9
61,62,64,65, 6A to 6E	Pharmaceutical & antibiotic raw materials	700	14.2
	All "end user" tariff lines	2503	7.4
	Total number of MFN tariff lines	6667	26.6

Note: Compiled from NBR tariff database

Chapter 5: Reconciling the trade statistics

A component of the project is a paper which provides detailed comparisons of the Indian and Bangladesh statistics of bilateral trade⁴⁷. One purpose of this study was to check whether there were any major discrepancies as to the general level of, and trends in, the total trade. Secondly, by making detailed comparisons, the object was to throw some light on the scale and scope of overinvoicing, underinvoicing, and similar practices, the likely products involved, and more broadly the potential scale of “technical smuggling”.

There are a number of well known problems that have to be allowed for in making comparisons of this kind, before much can be inferred on these two questions. They include in particular:

- a. Freight and insurance which increase cif values above fob values
- b. Time lags between the fob stage in the exporting country and the cif stage in the importing country⁴⁸
- c. Differences in the reporting periods of the statistics
- d. Differing valuation practices at the Customs services

In the case of the India-Bangladesh trade, *a priori*, differences attributable to (a) and (b) should be minor relative to trade with countries outside the South Asia region, certainly for the land border trade⁴⁹, and to a lesser extent for the sea trade, given the proximity of the Indian and Bangladesh ports. As regards (c), the Indian published trade statistics are for its April-March fiscal year, whereas the Bangladesh statistics are for its July-June fiscal year. As a spot check on how important this period difference might be, the Bangladesh import data over three years was reassembled into two Indian fiscal years, 1999/2000 and 2000/2001 for detailed comparison with Indian export data for the same periods. But (d) was a problem in 1999/2000 and before, in that during this period Bangladesh Customs was still using a predetermined list of “tariff values” as the base for Customs and other import duties on number of products, and these values, not invoice values, were entering the import statistics.⁵⁰ However, except for petroleum it was decided that this was probably not on its own a major source of discrepancies between the Indian and the Bangladesh data, on the grounds that the committee that was deciding on the tariff values was looking at international prices each three months and was fixing tariff values that would not have differed very greatly from normal cif prices in international trade⁵¹.

A more serious problem than these is that the Bangladesh NBR trade database does not record “back to back L/C” imports i.e. imports of duty free intermediate inputs used by Bangladesh bonded warehouse exporters, and so these are recorded in the Indian export statistics but omitted altogether from the corresponding Bangladesh NBR import statistics. As India is an important supplier of these inputs—mainly textile yarns and fabrics for Bangladesh’s garment exporters—this is the source of large discrepancies between the Indian export statistics and Bangladesh’s import statistics, both in the aggregate and when disaggregated.

⁴⁷ Rajesh Mehta (2004) *An Overview and Analysis of India’s Trade with Bangladesh*

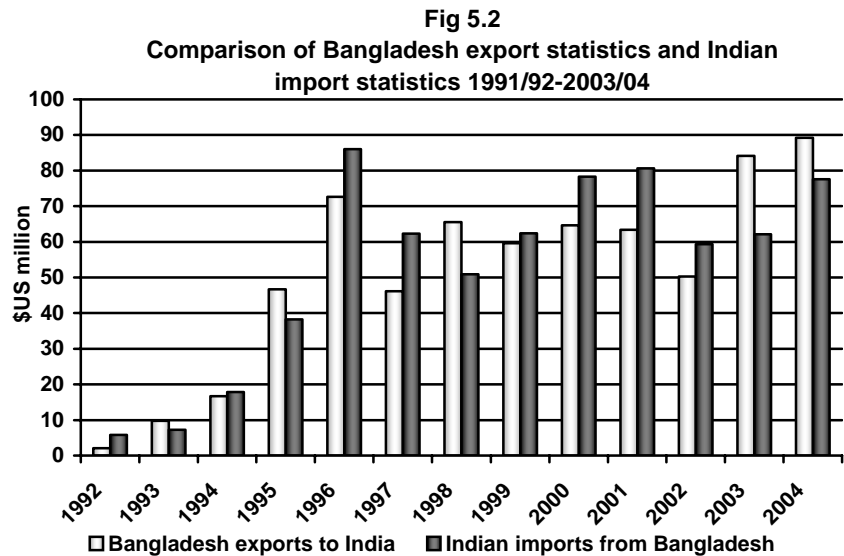
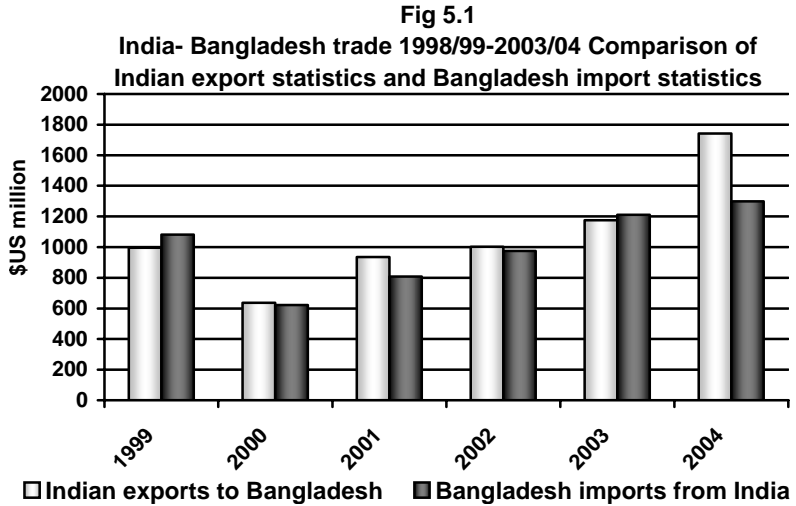
⁴⁸ This may place a given shipment in a later statistical period (e.g. fiscal year) in the importing country, and may affect the exchange rate at which the shipment is valued.

⁴⁹ This depends on the valuation practices at the land borders and how fob and cif prices are defined when all that is involved is crossing the border and transferring the goods from (say) an Indian truck to a Bangladesh truck.

⁵⁰ This practice was discontinued in FY 2001 for all products except POL (petroleum, oils and lubricants) and vessels imported for scrap.

⁵¹ In 1999/2000 854 8-digit HS products (about 13% of the total) were subject to tariff values

Fortunately payments under back-to-back LCs are recorded by Bangladesh Bank, although they are not disaggregated below 2-digit HS level and are not available before 1998/99. Even though the timing of these payments differs from Customs clearance times (which are the basis for the NBR import data), adding the totals to NBR's total import data, gives a very approximate correspondence between the general level of the two sets of data for the years 1998/99 to 2002/03. Both statistics also indicate similar year to year changes during this period (Table 5.1 and Fig 5.1). However there is a major discrepancy in 2003/04, when the recorded total Bangladesh imports are only about 75% of the value of recorded Indian exports. More generally, in four of the six years, recorded Bangladesh imports are less than recorded Indian exports, and over the six years total recorded Bangladesh imports are \$492 million (7.6%) less than total recorded Indian exports. Since the Indian exports are recorded



fob and the Bangladesh imports are or should be recorded cif, these differences are the opposite of expectations, even though the overall freight and insurance cost may not be very great owing to the trade that goes by the land border crossings. It is also unlikely that these discrepancies can be explained by timing differences, since the Bangladesh statistical year (July 1-June 30) lags the Indian statistical year (April 1-March 31) by three months and would should pick up most shipments from India that arrive in Bangladesh after the end of the Indian statistical year. Although data recording deficiencies and statistical errors may conceivably explain some of these differences, they are consistent with many reports of illegal practices at the Bangladesh Customs, especially at the Petrapole-Benapole land crossing, and with the large scale discrepancies between the Indian and Bangladesh data at product level, discussed below.

As regards the much smaller reverse trade from Bangladesh to India, the correspondence between Bangladesh's aggregate export statistics and the Indian import statistics is fairly close. Table 5.2 and Fig 5.2 show comparisons for the 13 years 1991/92 to 2003/04. For these comparisons there is no problem of unrecorded imports, since duty free imports for exporters are recorded by Indian Customs and included in India's import statistics, just as any other import. Differences between the statistics in individual years are substantial, including some years in which recorded imports in India are less than Bangladesh's exports, but for this trade the fiscal year difference between Bangladesh and India increases the likelihood that this

will happen, and timing differences of a few large shipments could create large proportionate discrepancies owing to the low volume of the total trade. Over the whole period, the difference between aggregate Indian imports and aggregate Bangladesh exports has the expected positive sign, and the positive margins (3.4% between 1992 and 1998, 2.2% between 1999 and 2004) correspond to the expectation that cost of freight and insurance is low. This does not mean there was no undervaluation or misclassification to avoid import duties occurring on the Indian side, only that it was not so egregious as to show up in the aggregate import statistics.

As well as comparing aggregates, the consultant study also compared the Indian export and Bangladesh import statistics for 1999/2000 and 2000/01 at HS 6-digit product level. The value differences were quite minor for most of the individual products that they analyzed –in 2000/01 within 10% (plus or minus) of the recorded Indian export values of 3013 products, out of a total of 3423 products that were recorded as being exported from India to Bangladesh⁵². However, when the study looked at a sample of products that had high values in either the Indian export statistics or the Bangladesh import statistics, large discrepancies were discovered, predominantly cases with lower values in the Bangladesh import statistics than in the Indian export statistics, but also the reverse i.e. where the recorded import values in Bangladesh considerably exceed the export values in India. The study then calculated the total discrepancy for textile products⁵³, and found that about three quarters of the aggregate discrepancy over all tariff lines was attributable to these products, and therefore probably simply reflected the fact that duty free “back to back L/C” exports to Bangladesh are not included in Bangladesh’s import statistics. However, it also pointed out and gave examples⁵⁴ of large discrepancies for many high value non-textile products.

For this synthesis report, a brief further analysis was undertaken of the data for the 50 products (defined as HS 6-digit level) with the largest absolute discrepancies in 2000/01. Textile products and a petroleum product were removed, leaving 41 products altogether which accounted for about half the total recorded Indian exports (net of textile exports) to Bangladesh in that year. The results are striking:

<i>41 major non-textile products exported from India to Bangladesh in 2000/01 (Indian fiscal year): Differences between Indian and Bangladesh trade statistics</i>					
	No of products (HS 6-digit)	Value fob in Indian trade statistics \$US million	Value cif in Bangladesh trade statistics \$US million	Difference \$US million	Difference as % of Indian fob value
All products	41	355	238	-117	-33%
Bangladesh value < Indian value	21	286	82	-203	-71%
Bangladesh value > Indian value	20	69	156	+87	+126%

The following examples give a better feel for what may lie behind these aggregates. Other examples are given in the consultant study. For nearly all the products there were similar differences in the same direction during 1999/2000.

There are many possible mundane reasons for these discrepancies, including timing differences⁵⁵ and simple classification or other mistakes at the Indian or Bangladesh Customs. However, four of the

⁵² See Mehta, op.cit, Table IV.3

⁵³ Ibid Table IV.6

⁵⁴ Ibid Table IV.4

⁵⁵ Comparisons over longer time periods for products with large discrepancies would provide a useful check on the likely importance of timing differences.

project consultant studies independently reported that “well informed sources” generally agree that illegal practices are widespread at Petrapole-Benapole, which is the by far the most important land-border crossing for India-Bangladesh trade. These reports mainly emphasize under-invoicing and misclassification to reduce Bangladesh import duties, and point out that in most cases the benefits of overinvoicing on the Indian side in order to obtain higher export incentives are far less than the extra import duties that would need to be paid in Bangladesh, assuming the export valuations are actually used at Bangladesh Customs. In this regard it should be noted that underinvoicing by Indian exporters in order to reduce Customs duties for Bangladesh importers, on its own does not explain lower import values for the same goods in Bangladesh import statistics: for that some of the shipments would have to be not recorded at all in Bangladesh, or recorded differently from the values provided to the Indian Customs.

		<i>Value fob in Indian trade statistics \$US million</i>	<i>Value cif in Bangladesh trade statistics \$US million</i>	<i>Difference \$US million</i>	<i>Difference as % of Indian fob value</i>
Products with Bdesb value< Indian value					
070310	Onions & shallots	8.3	3.1	-5.2	-63
100630	Milled rice	65.1	23.3	-41.8	-64
270119	Other coal (bituminous)	29.9	3.3	-26.6	-89
879600	Chassis fitted with engines (for buses, cars, three wheelers and trucks)	26.5	0.01	-26.5	-100
Product with Bdesb value> Indian value					
401120	New tyres used on buses/lorries rim size>15	6.3	13.5	+7.3	+115
841182	Gas turbines	nil	24.0	+24.0	+
845522	Rolling mills-cold	1.4	12.0	+10.6	+757
870210	Motor vehicles, diesel engine public transport type (=buses?)	0.8	10.0	+9.2	+1150

An interesting outcome of the trade statistics comparison which was not expected in advance, is the importance of substantially higher values of some Indian exports in Bangladesh than the export values of the same products in India. These differences in individual products seem to far exceed likely transport costs, and some products were simply not recorded at all in the Indian export statistics. In 2000/01 these cases were offsetting about half of the total apparent undervaluation in Bangladesh, and were thereby cancelling out a good part of the aggregate discrepancy between the two sets of trade statistics.

Leaving aside freight and insurance, recording mistakes and timing differences, apart from import duty evasion, there are also obvious income tax evasion motivations which could give rise to differences such as these. On the exporting side, Indian exporters might underinvoice or otherwise understate the value of their exports in order to reduce their income tax liabilities, and conversely Bangladesh importers might overstate the cost to them of imports in order to reduce their income tax liabilities. For overinvoicing in Bangladesh to be worthwhile, import duties would need to be zero or quite low, and the most likely candidates are therefore duty free intermediate inputs and capital equipment used by exporters. Imported intermediate inputs used by exporters are routinely exempt from import duties, and as pointed out in section 4 above, most machines imported by exporters are free of all import duties including the AIT (advance income tax) and VAT, by virtue of the special “capital machinery” tariff provisions for exporters. However it is also possible that in some cases it may pay to overinvoice products subject to positive but low import duties e.g. machines subject to the general “capital machinery” protective tariff of 7.5%.

In addition to income tax evasion, some researchers in Bangladesh (e.g. Muinul Islam ⁵⁶) have suggested that overinvoicing-especially of capital equipment imports- is used to accumulate unrecorded foreign exchange outside the country, which in turn finances illegal imports or is used to profit from free market premia on the official exchange rate. For a number of years free market foreign exchange premia for the Taka have been very small, but tax evasion and the various advantages of holding black money outside Bangladesh could still be relevant motivations and may explain some of these observed differences between the Indian and Bangladesh statistics.

These and other indications of widespread illegal Customs practices, especially at the Petrapole–Benapole crossing, are despite a number of Bangladesh government initiatives to reduce them. These initiatives include pre-shipment inspection (compulsory since 1999) of Indian consignments to Bangladesh by PSI inspectors in India⁵⁷, the use of new computers and software in Bangladesh to speed up clearance and reduce Customs official discretion⁵⁸, and the Bangladesh Bank’s requirement that to be cleared all imports require a letter of credit from a Bangladesh bank. It is possible that these measures may have reduced the scope and scale of illegal practices, but the project studies indicate that there are still many problems. In particular, it is reported that containers are tampered with between the factories or warehouses at which the PSI inspections take place and Petrapole⁵⁹, that PSI valuations are not always being recognised by Bangladesh Customs officials, and that LCs are being issued to meet formal requirements, but are not in practice being used to finance most Bangladesh land border imports from India⁶⁰. All of these issues would warrant further investigation, ideally by a coordinated joint effort involving both the Indian and the Bangladesh Customs services and other relevant organisations in both countries. A useful first step would be to systematically compare the Indian export and Bangladesh import statistics in more detail and for a longer period than was done for the project consultant study, focussing on products such as those mentioned above for which there are indications of large disparities.

Table 5.1: Comparison of Indian export statistics with Bangladesh import statistics 1998/99-2003/04

	Indian	Bangladesh import statistics			Difference (M-X)	Difference % of X
	exports statistics (X)	NBR database	Back to back LCs	Total (M)		
	\$ million	\$ million	\$ million	\$ million	\$ million	
1999	996	951	131	1082	86	8.7
2000	636	446	176	622	-14	-2.2
2001	935	629	178	807	-128	-13.7
2002	1002	839	136	974	-28	-2.8
2003	1176	1115	95	1210	34	2.9
2004	1741	1186	112	1298	-443	-25.4
1999-2004	6486	5166	827	5994	-492	-7.6

⁵⁶ This has been a theme in the writing of Muinul Islam e.g. in his chapter (pp 125-127) in Jayanta Kumar Ray and Prabir De (eds): *Promotion of Trade and Investment in the Eastern South Asian Subregion*. Bookwell, New Delhi 2003.

⁵⁷ There is a note on the operations of the Bangladesh PSI inspectors in India in Arun Goyal’s study of trade financing (pp 18-20). Arun Goyal (2004, October). *Study on Financing of India-Bangladesh Trade*.

⁵⁸ This contrasts with Customs clearance on the Indian side at the Petrapole-Benapole crossing, which is still being done by hand

⁵⁹ In 2004 one knowledgeable person interviewed in Kolkata said that better enforcement of the PSI system is deterred by an atmosphere of intimidation (including physical violence) in and around Petrapole.

⁶⁰ This topic is discussed in Goyal’s trade financing study

Table 5.2: Comparison of Bangladesh export statistics and Indian import statistics 1991/92-2003/04

	Bdesh stats Exports to India \$m	Indian stats Imports from Bdesh \$m	Indian M minus Bdesh X \$m	Diff as % of Bdesh M %
1992	2.1	5.8	3.7	180.2
1993	9.8	7.3	-2.5	-25.3
1994	16.7	17.9	1.2	6.9
1995	46.7	38.2	-8.5	-18.2
1996	72.6	86.0	13.4	18.5
1997	46.1	62.3	16.2	35.1
1998	65.5	50.9	-14.6	-22.3
1999	59.6	62.4	2.8	4.7
2000	64.6	78.3	13.7	21.2
2001	63.4	80.6	17.2	27.1
2002	50.3	59.3	9.0	17.9
2003	84.1	62.1	-22.0	-26.2
2004	89.2	77.6	-11.6	-13.0
1992- 1998	259.5	268.4	8.9	3.4
1999- 2004	411.2	420.3	9.1	2.2

Chapter 6: Bangladesh imports from India: composition, trends and potential under an FTA

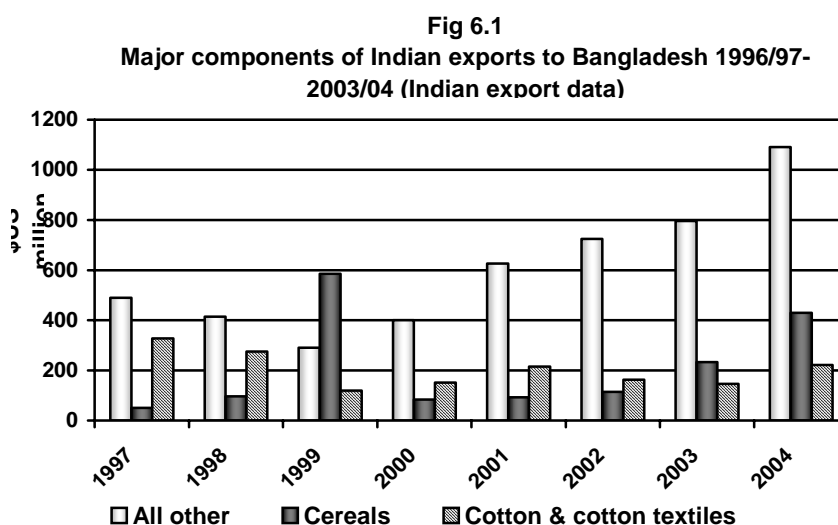
As discussed in the previous section, there are large discrepancies between the Indian statistics of exports to Bangladesh and the Bangladesh statistics of imports from India, both in the aggregate and even more so at the level of individual commodities. Disaggregating the Bangladesh import statistics (Table 6.1) by some major commodity categories shows the following:

- Highly variable but sometimes large imports of cereals (mainly wheat and rice) from India. Bangladesh is also importing from other countries, but India has been the main supplier in recent years.
- An apparently declining role of India as a supplier of duty free intermediate goods (mainly textiles) for Bangladesh's export RMG sector. According to the Bangladesh import data, in 2003/04 "Back-to-back LC" imports from India only accounted for 3.5% of its total "Back-to-back LC" imports
- That India is supplying fairly constant shares of Bangladesh's imports of basic raw materials, intermediate goods used for domestic production, capital goods and non-cereal final consumer goods

The Indian export statistics have been not been sorted into these categories, but a separation into the three categories illustrated in Fig 6.1 (cotton and cotton textiles, cereals and "all other") confirms the importance and variability of cereal exports, and is consistent with a declining Indian role in the supply of inputs to Bangladesh exporters, since this is the main destination of its cotton textile exports. However, according to these statistics, "all other" exports have been growing very rapidly, on average at around 15% annually since 1996/97, with especially big increases in 2002/03 and 2003/04. This suggests that at least one of the following categories of Indian exports to Bangladesh –basic raw materials, intermediate goods used in domestic production, capital goods, or non-cereal consumer goods, have been growing faster than indicated by the Bangladesh import statistics.

India exports a wide range of products to Bangladesh. According to the Indian export statistics for 2003/04, there were at least some exports in all but 4 of the 98 HS chapters. About a third of total exports were primary agricultural, fish and livestock products, 6.6% processed foods and drinks (including animal foods), and most of the rest manufactured products (Table 6.2). Leaving aside textile and clothing exports, most of which go duty free to Bangladesh RMG exporters, India was supplying 21.5% of Bangladesh's total imports for use in the domestic market.

Table 6.3 shows the top 25 product groups (defined by 2-digit HS codes) exported by India to Bangladesh in 2003/04, as recorded in India's trade statistics. To improve comparability with Bangladesh's import data, the textile and clothing (T&C) HS chapters were removed in constructing the table, because duty free imports for exporters ("back-to-back LC" imports) are not included in the NBR database, and these are mostly T&C products for Bangladesh RMG



exporters. India's principal exports are then compared with Bangladesh's total imports of the same product groups as recorded in the NBRs database for Bangladesh's fiscal 2003/04, and Bangladesh's average protective tariffs during 2003/04 are shown for each product group. The average tariffs allow for para-tariffs and have been calculated on three different bases: as an unweighted average of all the MFN 8-digit tariff lines in each chapter; as an unweighted average including all MFN tariff lines plus reduced "end user" tariffs plus all reduced preferential tariffs; and finally, as in the second case but weighting by total imports during the year.

Table 6.1: Indian exports to Bangladesh 2003/04 (from Indian export statistics)

<i>HS code</i>		<i>\$ US million</i>	<i>Share %</i>
1-14	Primary agricultural, fish, and livestock products	571	32.8
15-24	Processed foods and drinks (including animal foods)	115	6.6
25-49	Miscl mineral and manufactured goods	318	18.3
50-63	Textile fibres, textiles and clothing	269	15.4
64-98	All other (including machinery and transport equipment)	468	26.9
TOTAL		1741	100.0

During 2003/04 the 25 product groups accounted for 81% of India's total recorded exports to Bangladesh, and almost 96% of total exports to Bangladesh after excluding T&C exports. The fiscal year difference, the exclusion of T&C imports and other factors discussed previously should be borne in mind in comparing the Indian and Bangladesh statistics, but the data nevertheless provide a useful preliminary overview of the likely consequences for Bangladesh of free trade with India. In particular note that:

- India's share of Bangladesh's total imports of each of these product groups is quite high: more than half for 8 product groups, between 20% and 30% for 7 product groups; between 10% and 20% for 7 product groups; and in only three cases less than 10%.
- Average protective tariffs for most of the product groups are high. Even after allowing for and averaging over "end user" tariff lines, and weighting by imports, only 5 of the 25 product groups (cereals, non-electrical machinery, animal foods, pharmaceuticals and railway equipment) have average tariffs of less than 10% , and the average import weighted tariff of the other 20 product groups is 29%

This means that Indian exporters to Bangladesh are successfully competing with exporters in the rest of the world (ROW) and have achieved substantial shares in Bangladesh's import markets, while in most cases paying relatively high tariffs which in principle are the same for all exporters. If Bangladesh's MFN tariffs for the rest of the world were to remain the same while India received duty free treatment under SAFTA or a bilateral FTA, for most of these products Indian exporters would have a substantial price advantage in products in which it appears from the trade data they are already highly competitive.

The potential for expanded Indian exports to Bangladesh is supported by a very interesting NCAER paper⁶¹ which was prepared as part of the project. The paper outlines the results of a survey carried out in Kolkata by an NCAER team, and a survey in Bangladesh by Data International which asked for information on domestic prices of a set of representative products.⁶² The Kolkata survey received responses from 82 firms exporting to Bangladesh and from 50 manufacturers who were supplying them. Many responses were incomplete and the coverage of individual questions (including price information)

⁶¹ Das, Samantak, Somnath Mukherjee and Sowmya Srinivasan, *Study of a Sample of Products/Industries in India*. Mimeo 2003.

⁶² The Kolkata survey was done during July and August 2002, and the Bangladesh survey a few months earlier.

was not the same in India and Bangladesh. As regards comparative prices in the two countries, the sample of reasonably reliable responses that could be compared in the end was quite small and covered only 30 products. Nevertheless, the results were striking, indicating that prices of 25 of the 30 products were higher in Bangladesh, and in most cases very considerably higher-on average for the 30 products about 62% higher.⁶³

	<i>Number of products with prices</i>			
	Higher in India	Higher in Bangladesh	Total number of products	Average ratio of Bangladesh price to Indian price
Agricultural products	1	9	10	1.83
Processed foods	-	4	4	2.00
Manufactured products	4	12	16	1.39
TOTAL	5	25	30	1.62

The NCAER paper also provides information for these products on indirect taxes in the two countries. In Bangladesh, except for exempted products, there is just the 15% VAT, but in India (also except for exempted products) there is the central government excise tax –usually 16%- and at the time of the survey the central sales and state sales taxes⁶⁴. The paper does not discuss the implications of the indirect taxes for the price comparisons, but a finding of major importance emerges when these are factored in. This is that **the combined incidence of the central excise tax and central and state sales taxes in India is in general much higher than the Bangladesh VAT**. This means that reported retail price comparisons if anything understates the excess of Bangladesh prices over Indian prices after the indirect taxes have been removed. As a rough test of this, for this synthesis, using arbitrary assumptions on retail margins and the indirect taxes reported in the paper, approximate pre-tax ex-factory prices were derived and compared for the five products which according to the surveys had lower retail prices in Bangladesh⁶⁵. For one product, this reversed the comparison, and in the other four it substantially reduced the estimated excess of the Indian price.

<i>Product</i>	<i>Estimated ratio of Bangladesh price to Indian price: retail incl indirect taxes</i>	<i>Estimated ratio of Bangladesh price to Indian price: tax free wholesale or ex-factory</i>	<i>Bangladesh: % of VAT to retail price</i>	<i>India: % of indirect taxes to retail price</i>
Domestic soap	0.85	0.98	11.8	22.8
Dry red chilly	0.89	0.95	nil	6.5
Ceiling fan (sweep type 900-1200 mm)	0.78	0.85	12.5	18.3
UPS (600-625 VA)	0.99	1.15	11.9	22.7
Paints	0.70	0.81	nil	13.8*

* The comparison for paints is of wholesale prices only

⁶³ 27 of these comparisons are of retail prices and 3 of wholesale prices. 12 of the retail price comparisons were confirmed by comparisons of wholesale prices of the same products. Details of the comparisons are given in Table A.4 of the NCAER report.

⁶⁴ The NCAER paper reports state sales taxes in West Bengal only, and not central sales taxes or sales taxes in other states. Some products shipped to West Bengal from other states might be subject to central sales tax in addition to the state sales tax, so the total incidence of indirect taxes could be even higher than indicated in the paper.

⁶⁵ For this exercise it was assumed that in Bangladesh the VAT is collected at ex-factory and wholesale levels in Bangladesh but not at retail level.

The surveys were not able to obtain adequate data on tax free ex-factory or tax free wholesale prices which could be compared directly, but the higher incidence of indirect taxes in India suggests that the potential for exports from India to Bangladesh is even greater than suggested by the comparisons of tax inclusive prices at retail level, since legal exporters are exempt from these indirect taxes, in addition to which they are exempt from or receive rebates of import duties and indirect taxes on their inputs. Conversely, allowing for the indirect tax difference—at least for this small sample of products—reduces even further the likelihood that there would be many exports from Bangladesh to India under free trade. However, this has to be interpreted carefully, since the NCAER sample was of products already being exported by India, so it is unlikely to include products that would be traded in the other direction⁶⁶.

The incidence of indirect taxes also confirms suggestions in some of the industry case studies that illegal “bootleg” smuggling from India to Bangladesh in border areas is inhibited by the fact that some if not all of the smugglers on the Indian side pay tax inclusive prices for the goods that are smuggled. As pointed out in the case study on sugar, this means that both the Indian central government and the Indian state governments are obtaining part of the smuggling economic rents from the excise tax and the sales taxes on the smuggled goods, which in effect constitute an Indian export tax on products which are smuggled to Bangladesh.

The NCAER survey also asked Indian traders who were already exporting to Bangladesh by what percentage they would expect their exports to expand under three different hypotheses on Bangladesh tariff reductions (50%, 75% and 100%). For the free trade alternative (100% tariff reduction) the average estimated increase for 58 products was 34 %, distributed as follows:

<i>Type of product</i>	<i>Number of products</i>	<i>Average of expected increases in exports to Bangladesh %</i>
Agricultural	14	31
Processed food	4	45
Manufactured	39	35
Mineral	1	10
All products	58	34

For only 4 of the 58 products was the expected increase in exports 10% or less (wheat, C.I. sheets, paints, and bauxite), and not surprisingly three of these products were already facing low Bangladesh protective tariffs⁶⁷.

The aggregated data on Indian exports to Bangladesh and the NCAER exporter survey suggest that there is considerable potential for trade diversion with an FTA i.e. Indian exporters would be able to undercut ROW suppliers and substantially increase their shares in Bangladesh’s import markets. This in turn would have important economic welfare consequences. One immediate consequence would be lost government revenue from the protective tariffs that would no longer be applied to imports from India. For the product groups for which Indian export data is provided in Table 6.2, assuming that under an FTA India would not supply crude oil and petroleum products and omitting the mineral fuels and oils HS chapter, a very approximate estimate of the total government revenue from protective tariffs on 2003/04

⁶⁶ A similar survey was not carried out on the Bangladesh side. A useful follow up to this study would be to put similar questions to Bangladesh traders exporting to India. However, the sample would be much smaller than the Indian sample, owing to the low volume of this trade and the relatively few products involved (see section 7 below).

⁶⁷ Wheat 7.5%, C.I. sheets 10%, bauxite 3.5%. The NCAER questionnaire did not attempt to distinguish protective tariffs from the (in principle) non-protective import taxes i.e. the VAT and the advance income tax. It is likely that the respondents may have had in mind all the Bangladesh import taxes including these.

imports is \$738 million, of which \$207 million was from imports of these products from India⁶⁸. Under an FTA the government revenue loss would therefore at least be \$207 million, and it would be greater than this to the extent that Indian exporters were to increase their shares in these import markets. But increased market share would be the outcome of lower prices and/or better quality and service for Bangladesh buyers of the imports, and at the same time would increase competition for Bangladesh producers. In evaluating the net economic welfare effect of the FTA in Bangladesh, these benefits to Bangladesh buyers and some potential economic costs for producers would need to be weighed with the government revenue effects. Under the project, a methodology for doing this kind of evaluation at the level of individual industries was developed and some industry case studies were undertaken. This work is briefly summarised in section 10.

⁶⁸ These are very rough estimates made by applying the import weighted tariff rates given in Table 6.3 to total 2003/04 imports and are indicative of orders of magnitude only. They assume that para-tariffs as well as Customs duties would be zero under an FTA, but that Bangladesh's VAT would be applied in the normal way to imports from India. The estimates would ideally be done at a more disaggregated level and using if available actual tariff collections.

**Table 6.2: Bangladesh Imports FY 1996 & FY 2001-FY 2004: Composition and Indian shares
(using Bangladesh trade statistics)**

Description	1995-96		2000-01		2001-02		2002-03		2003-04	
	Imports million \$	Share %	Imports in million \$	Share in %	Imports million \$	Share in %	Imports million \$	Share in %	Imports million \$	Share in %
Imports from World										
Basic Raw Materials	758	11.5	903	10.8	852	9.1	1,015	10.7	1,409	12.8
Intermediate Goods: total	3,632	54.9	4,956	59.3	4,761	51.1	5,240	55.3	5,899	53.4
Intermediate Goods: Domestic Consumption	1,936	29.3	2,082	24.9	2,169	23.3	2,445	25.8	2,702	24.5
Intermediate Goods: Back- to-Back-L/C & EPZ Imports	1,696	25.7	2,874	34.4	2,592	27.8	2,795	29.5	3,197	29.0
Capital Goods	1,165	17.6	1,463	17.5	2,555	27.4	1,447	15.3	2,016	18.3
Final Consumer Goods: Total	1,057	16.0	1,036	12.4	1,151	12.3	1,775	18.7	1,720	15.6
Final Consumer Goods: Wheat & Rice	479	7.2	251	3.0	246	2.6	345	3.6	332	3.0
Other Final Consumer Goods	578	8.7	785	9.4	905	9.7	1,430	15.1	1,387	12.6
Total	6,612	100.0	8,357	100.0	9,319	100.0	9,477	100.0	11,044	100.0
Imports from India										
Basic Raw Materials	117	11.1	84	10.4	126	13.0	135	11.2	218	16.8
Intermediate Goods: Domestic Consumption, Back-to-Back L/C	442	42.1	405	50.2	400	41.1	436	36.0	448	34.5
Intermediate Goods: Domestic Consumption	276	26.3	227	28.2	264	27.1	340	28.1	336	25.9
Intermediate Goods: Back- to-Back-L/C	165	15.8	178	22.0	136	13.9	95	7.9	112	8.6
Capital Goods	125	11.9	115	14.3	176	18.1	156	12.9	178	13.7
Final Consumer Goods: Total	367	34.9	202	25.1	272	27.9	484	40.0	455	35.0
Final Consumer Goods: Wheat & Rice	273	26.0	73	9.0	116	11.9	274	22.7	231	17.8
Other Final Consumer Goods	93	8.9	129	16.0	156	16.0	209	17.3	224	17.2
Total	1,051	100.0	807	100.0	974	100.0	1,210	100.00	1,299	100.0
Indian share of imports %										
Basic Raw Materials	15.4		9.3		14.8		13.3		15.5	
Intermediate Goods: Total	12.2		8.2		8.4		8.3		7.6	
Intermediate Goods: Domestic Consumption	14.3		10.9		12.2		13.9		12.4	
Intermediate Goods: Back- to-Back-L/C	9.8		6.2		5.2		3.4		3.5	
Capital Goods	10.8		7.9		6.9		10.8		8.8	
Final Consumer Goods: Total	34.7		19.5		23.6		27.3		26.5	
Final Consumer Goods: Wheat & Rice	57.1		29.1		47.0		79.6		69.5	
Other Final Consumer Goods	16.1		16.5		17.2		14.6		16.1	
Total	15.9		9.7		10.5		12.8		11.8	

Sources: NBR database (Customs clearance basis) and Bangladesh Bank for Back-to-Back LC imports (payment basis). Total imports from India during FY 04 in this Table are much less (by about \$400 million) than total exports to Bangladesh during Indian FY 04 shown in the Indian export statistics. See discussion in section 5 above

Table 6.3: Indian exports to Bangladesh 2003/04: 25 principal products exported (as defined by HS 2-digit product codes) . Textile and clothing HS chapters 50-63 excluded

	HS code	Indian exports (X)	Bdesh total imports (M)	Share of X in M	Bangladesh protective tariffs rates % Unwtd avg MFN lines	Unwtd avg all lines	Wtd by total imports all lines
		\$ million	\$ million	%			
25 largest exported product groups							
Cereals (mainly rice and wheat)	10	429.2	357.7	120.0	11.00	11.00	6.82
Non-electrical machinery	84	98.9	1185.8	8.3	18.86	10.93	7.75
Vegetables	7	92.4	166.9	55.3	32.22	31.48	11.08
Vehicles-cars, trucks, buses, tractors	87	82.4	354.9	23.2	42.87	38.92	24.19
Articles of iron & steel	73	81.9	86.3	94.8	32.68	30.34	21.90
Iron & steel	72	74.3	268.5	27.7	18.35	18.19	13.13
Animal food	23	72.9	63.2	115.4	1.65	1.50	0.16
Mineral fuels, mineral oils etc	27	67.5	813.1	8.3	29.64	27.68	43.65
Electrical machinery	85	52.3	438.1	11.9	25.61	19.83	15.07
Aluminium & articles thereof	76	37.1	69.1	53.7	23.88	20.25	14.22
Salt, lime & cement, earths, stone etc	25	36.7	220.3	16.6	23.43	22.20	25.38
Rubber & rubber articles	40	34.6	59.9	57.8	22.73	19.13	25.78
Organic chemicals	29	34.4	183.9	18.7	15.17	14.03	10.71
Plastics and plastic articles	39	33.4	235.1	14.2	26.42	23.91	18.62
Sugar and sugar confectionery	17	32.1	134.4	23.9	54.59	46.67	92.78
Dyes, pigments, tanning agents, paints etc	32	29.1	84.9	34.3	20.07	19.45	11.52
Edible fruit and nuts	8	25.7	37.3	68.9	35.23	35.23	76.15
Inorganic chemicals	28	21.7	81.2	26.7	17.38	16.53	16.85
Paper, paperboard, paper articles	48	14.3	106.5	13.4	28.92	27.25	28.68
Pharmaceuticals	30	14.0	94.1	14.9	8.58	9.22	3.86
Coffee, tea, spices	9	13.8	37.3	37.0	45.23	44.71	43.04
Miscl chemical products	38	12.3	74.3	16.5	22.89	20.76	16.34
Railway equipment	86	5.6	9.1	61.3	21.18	21.18	8.24
Optical, photographic etc equipment	90	5.4	94.1	5.8	13.50	8.50	10.13
Books, newspapers etc	49	5.1	14.9	34.2	16.68	16.68	20.05
Total: 25 principal products exported		1406.8	5271.0	26.7	n.a	n.a	n.a
69 other product groups		65.5	1589.3	4.1	n.a	n.a	n.a
Total : all product groups (84 HS chapters)		1472.3	6860.4	21.5	n.a	n.a	n.a

Notes: The Indian export statistics are for the April-March 2003/04 fiscal year whereas the Bangladesh NBR statistics of total imports are for Bangladesh's July-June 2003/04 fiscal year. This is probably the principal reason Indian cereal and animal food exports exceed Bangladesh total imports. Duty free intermediate inputs imported by Bangladesh exporters are not included in the Bangladesh NBR database. Most of these are textiles which are included in the Indian export statistics. To make the two data sets more comparable the textile and clothing HS product groups (HS 50-63) have been omitted from this table i.e. from both Indian exports and Bangladesh imports. The protective tariffs include para-tariffs as well as Customs duties and are averages of the 8-digit products included in each 2-digit HS chapter. The unweighted average of MFN lines excludes all "end user" and preferential tariffs within each 2-digit chapter. The unweighted average for all lines includes the MFN tariff lines and end-user and preferential tariffs which are shown as separate tariff lines for each 8-digit product to which they are applied. The import weighted tariffs are calculated using all the tariff lines including the end-user and preferential reduced tariffs.

Chapter 7: Bangladesh exports to India: composition, trends and prospects under an FTA

As discussed previously, Bangladesh's exports to India, after increasing quite rapidly in the early 1990s from almost negligible levels, levelled off after 1995/96 and in 2003/04 were about the same in nominal US dollars, and lower in inflation adjusted dollars, than they had been 9 years earlier (Fig 5.2). From India's perspective they are a miniscule share of its total imports (less than 0.1%) and are only about 1% of Bangladesh's total exports. Since 2001/02 they have been increasing fairly rapidly, and according to the most recent Indian import statistics, this increase was sustained until India's 2005/06 fiscal year at roughly a 30% rate, rising to \$120 million in 2005/06. However it was from a very low level of only \$50-60 million in 2001/02⁶⁹. These levels are much too low to be confident in projecting longer term trends, because the exports are dominated by just a few products, changes in which can cause large proportionate changes in the totals. For example, the increase between 2002/03 and 2003/04 was almost entirely due to increased exports of just one product, anhydrous ammonia.

About two thirds of Bangladesh's exports to India consist of this one product, (which is imported duty free as an input into India's urea industry) plus raw jute. In 2003/04 there were only seven products (including these two) with exports exceeding \$1 million, and between them these seven accounted for 87% of Bangladesh's total exports. As indicated in Table 7.1, there were only 29 products (defined at HS 6-digit level) with Indian imports exceeding \$100,000.

To what extent is the very low level and slow growth of Bangladesh exports to India a consequence of high tariffs and/or other restrictions in India? In discussing this it is useful to distinguish four broad categories of imports for which there are different protection policies in India.

Industrial products (other than textiles and clothing) without SAPTA preferences. As noted in section 3, since 20001/01 India has been providing SAPTA preferences to Bangladesh on about 2925 6-digit tariff lines, about 58% of the total number of lines. This leaves about 2075 products without SAPTA preferences. Omitting textiles and clothing and the "agricultural" HS products (discussed separately below), there are still a large number of mainly manufactured products for which imports from Bangladesh are treated on an MFN basis in the same way as imports from other countries without preferences. More products fall into this category to the extent that preferences are or would be precluded for Bangladesh by the SAPTA rules of origin. For these products typical Indian industrial MFN tariffs came down from 44.9% in 20001/04 to 30.8% in 2003/04, to 20% in 2004/05, and to 15% in 2005/06. Despite this steep decline in India's protection rates (illustrated in Fig 3.6) only 7 Bangladesh industrial products without SAPTA preferences appear in India's 2003/04 import basket as summarized in Table 7.1, and then at very low annual import levels of no more than about \$300,000 per product. Very little change is apparent from the import data for the first three quarters of 2004/05. Moreover, during this period none of these products were subject to India's general import licensing system, which was already lifted for Bangladesh and the other SAFTA countries in 1998. This suggests that most of these industrial products are not being produced in Bangladesh, or if they are, that the Bangladesh producers have not found it profitable to compete either with producers in other countries in supplying India, or with domestic Indian producers even though Indian industrial tariffs are now at historically low levels.

⁶⁹ According to export data from the Bangladesh Export Promotion Bureau, Bangladesh exports to India shot up to \$242 million in Bangladesh's fiscal 2005/06, compared to \$144 million in the preceding year. Divergence between the two data is partly due to the difference in fiscal years: April-March for India and July-June for Bangladesh.

Table 7.1: Indian imports from Bangladesh during Indian FY 04: comparison of MFN and preferential SAPTA tariffs

HS code			Indian imports FY 04		2003/04 tariff		2004/05 tariff		2005/06 tariff	
			\$US million	% of total	MFN	SAPTA	MFN	SAPTA	MFN	SAPTA
					pref rate		pref rate		pref rate	
28	1400	Anhydrous ammonia	31.74	40.9	0	0	0	0	0	0
53	0310	Raw jute	20.43	26.3	5	2.5	5	2.5	5	2.5
03	0269	Hilsa fish	5.01	6.5	35.2	19.6	30	15	30	15
62	0520	M&B woven shirts-cotton	4.17	5.4	49.7	27	44.8	22.4	46.2	23.1
53	1010	Jute fabrics	2.2	2.8	30	14.4	20	8	15	6
08	0290	Betel nuts & other nuts	2.19	2.8	35.2	16.5	30	12	30	12
27	0119	Steam coal	1.85	2.4	30	30	20	20	15	15
56	0710	Twine ropes jute & other fibres	0.64	0.8	24.8	12.3	20	8	15	6
41	0719	Leather whole hide	0.42	0.5	30	27.4	20	18	15	13.5
34	0119	Household soaps	0.25	0.3	36	4.6	20	0	15	0
41	0411	Wet blue	0.24	0.3	30	27.4	20	18	15	13.5
41	0419	Wet-Other	0.24	0.3	30	27.4	20	18	15	13.5
41	0449	Dry-Other	0.22	0.3	30	27.4	20	18	15	13.5
84	4790	Other knitting machines	0.21	0.3	30.8	30.8	20	20	10	10
84	7982	Mixing, stirring etc machines	0.21	0.3	30.8	30.8	20	20	15	15
04	0613	Shrimp & prawns frozen	0.19	0.2	35.2	19.6	30	15	30	15
84	8590	Other machinery-parts	0.19	0.2	30.8	30.8	20	20	15	15
52	0420	Cotton sewing thread -retail sale	0.18	0.2	24.8	14.4	20	10	15	7.5
84	4311	Offset printing machy	0.18	0.2	30.8	30.8	20	20	15	15
84	4511	Cotton carding machines	0.18	0.2	30.8	30.8	20	20	10	10
52	0299	Other cotton waste	0.17	0.2	19.6	11.8	15	7.5	15	7.5
28	0111	Toilet soaps	0.16	0.2	36	4.6	20	0	15	0
22	0290	Fruit juice or pulp based drinks	0.15	0.2	35.2	35.2	30	30	30	30
52	0522	Cotton single yarn	0.15	0.2	24.8	14.4	20	10	15	7.5
85	0790	Accumulator (battery) parts	0.15	0.2	30.8	11.2	20	5	15	3.75
20	0980	Mango & other juices	0.11	0.1	35.2	11.8	30	7.5	30	7.5
39	1729	Tubes & hoses	0.11	0.1	36	17.2	20	8	15	6
85	2510	Broadcast equipment sub-system	0.11	0.1	30.8	30.8	20	20	15	15
62	0590	M&B woven shirts-other fibres	0.1	0.1	84.5	44.9	49.8	24.9	51.4	25.7
Subtotal 29 products-avg tariffs			72.15	92.9	31.5	20.9	22.2	13.7	18.7	11.2
All other imports			5.48	7.1						
Total imports			77.63	100.0						
9 products with no prefs-avg tariffs			34.82	44.9	27.8	27.8	18.9	18.9	13.9	13.9
20 products with prefs-avg tariffs			37.33	48.1	33.1	17.8	23.7	11.4	20.9	10.0
20 products with prefs-wtd avg tariffs					19.6	10.4	16.7	8.1	16.2	7.9

Notes: Import data from India Ministry of Commerce DGFT website. Tariffs from Arun Goyal Easy Reference Customs Tariff, various editions. Tariffs for M&B (mens' & boys') shirts are specific tariffs applied to unit value of imports from Bangladesh in 2003/04. The MFN ad valorem tariff equivalents for the MFN tariffs assume the same unit values. The weighted averages are weighted by imports from Bangladesh. Hence the MFN rates show what the weighted average tariff on Bangladesh imports would have been in the absence of preferences. 2003/04 imports are used as weights in estimating the 2004/05 and 2005/06 weighted averages since import data for these years is not available. Note that rules of origin (maximum non-SAPTA content 70%) have to be satisfied for the preferential tariffs to be applied. Note also that the SAPTA preference did not apply to the Indian Sadd import tax so the de facto preference was less than the nominal preference during 2003/04 and before. The Sadd tax was abolished in January 2004.

Industrial products (other than textiles and clothing) with SAPTA preferences. Most of India's 2925 SAPTA preferences for Bangladesh are on industrial products, and the most frequent concession rate is 50%. Assuming this preference rate, a typical industrial preferential tariff for Bangladesh has declined during the past five years as follows:

	<i>MFN tariff %</i>	<i>Preferential tariff %</i>	<i>Price advantage for Bangladesh exporters over MFN exporters⁷⁰</i>
2001/02	41.3	23.0	13.0
2002/03	36.0	20.3	11.5
2003/04	30.8	17.7	10.0
2004/05	20.0	10.0	8.3
2005/06	15.0	7.5	6.5

From the perspective of actual or potential Bangladesh exporters to India (or equally from the perspective of Indian importers) the reductions in the preferential tariff since 2001/02 have greatly reduced the price disadvantage of Bangladesh exporters viz a viz domestic Indian suppliers. At the same time, however, the price advantage of Bangladesh exporters over MFN suppliers has also declined, from about 13% in 2001/02 to 6.5% in 2005/06.

Despite the large number of substantial SAPTA preferences and the decline in preferential tariffs during this period, only seven industrial products with preferences appear among India's principal imports from Bangladesh in 2003/04, and the imports of each of these were less than \$500,000 (Table 7.1). For a number of these products the rates of preference are low (e.g. 10% for processed hides and skins) and so the preferential tariffs are not much less than MFN tariffs, but for others imports were very small despite very substantial preferences. In particular, the preferential tariffs for household soaps and toilet soaps were only 4.6% versus MFN tariffs of 36%, but Indian imports from Bangladesh were only \$250,000 and \$160,000 respectively. This almost complete absence of response of Bangladesh exports to the numerous and fairly substantial Indian preferences under SAPTA, and to the decline of the preferential tariffs over the period, suggests once again that Bangladesh producers are probably not producing many products that are in demand in India. Alternatively, if these products are being produced in Bangladesh, it seems that, despite declining Indian tariffs, Bangladesh producers' costs are too high to compete with Indian producers, or with exporters in other countries who have to pay the higher MFN tariffs.

Textile and clothing (T&C)⁷¹ products Three quarters of Bangladesh's exports are ready made garments, most of which go the US and Europe. How have these products been faring in the Indian market, and would Bangladesh's RMG industry export much to India if there were a bilateral FTA with India, or if the T&C sector is not put on a SAFTA negative list? These questions are explored in a case study prepared for the project on the RMG industry.⁷² The case study focuses on mens' and boys' woven cotton shirts, which are major Bangladesh RMG exports, in order to make some more general points about the likely consequences of free trade between the two countries in the T&C sector as a whole. As background, the paper points out that Bangladesh RMG producers appear to have a marked labour cost advantage over RMG producers in India, owing to lower wages and similar labour productivity, but that India's specific duties on many fabrics and garments (see section 3 above) –as intended- have succeeded in preventing any substantial penetration of its domestic markets by developing country T&C producers.

⁷⁰ Defined as the difference of the preferential tariff inclusive price from the MFN tariff inclusive price, expressed as a percentage of the MFN tariff inclusive price

⁷¹ HS 50-63

⁷² Garry Pursell (2005, March). *Free Trade Between India and Bangladesh? A Case Study of the Ready Made Garment Industry*

Under SAPTA, Bangladesh RMGs benefits from Indian preferences –mainly either 50% or 60%-and these are applied to reduce to both the *ad valorem* and the specific components of compound tariffs. These preferences are substantial-for example (see Fig 3.5) in 2005/06 the *ad valorem* equivalent of the preferential specific tariff for Bangladesh on a \$4 cotton shirt is estimated at 23.7%, whereas the *ad valorem* equivalent of the tariff for a \$4 MFN sourced shirt-say from China- would be 47.3%. MFN tariffs at this level appear to be restricting Indian imports from MFN sources to high value brands and products, and to be precluding any substantial penetration from these countries of India’s mass consumption, low priced domestic markets. Presumably helped by this protection and the SAPTA preference advantage, Bangladesh RMG exports to India-almost entirely woven cotton shirts -grew fairly rapidly after 1999/2000 up to 2003/04, but the total level in that year (\$4.57 million) was still tiny both in relation to the Indian domestic RMG market and to Bangladesh’s total RMG exports. This general point is also symptomatic of the low level of Bangladesh exports of other T&C products to India (see Table 7.1).

The case study then considers what would happen under an India-Bangladesh FTA on the assumption that India would retain its specific tariffs on imports from MFN sources but either abolish them just for Bangladesh as part of a bilateral FTA, or for all the SAARC countries as part of SAFTA. Using the example of mens’ and boys’ woven cotton shirts, it works through the economic welfare consequences on various alternative assumptions about the likely demand response in India and the supply response in Bangladesh. This discussion brings out a number of points which overall suggest that there is a quite a low likelihood that there would be very substantial Bangladesh RMG exports to India even under this very favourable policy scenario, at least in the short to medium run. In particular:

- India is also a major exporter of RMGs, in 2003/04 with exports of \$6.2 billion versus Bangladesh’s exports of \$4.9 billion.
- It also has a very large and diversified textile industry which exports on its own account and supplies its RMG firms. By contrast, Bangladesh’s textile industry-especially the fabric sector-is a problem industry with high costs and high domestic prices, and is protected against imports by very high tariffs. As a result, Bangladesh’s RMG exporters rely mainly on imported yarns and fabrics.
- The paper argues that the very high protection levels provided by India’s specific duties on fabrics and garments are mostly redundant by wide margins. That is, actual domestic prices in India of all T&C products-yarns, fabrics, garments, and made-ups-are probably not far above and may even be below prevailing international prices at the cif stage in India. This generalization is partly based on reports that imports for the domestic market (as distinct from duty free imports of textile inputs by RMG exporters) of T&C products not subject to specific duties, have so far been minimal despite substantial reductions in *ad valorem* tariffs. The report also notes that Sri Lanka-which is a major RMG exporter has had negligible RMG exports to India, despite the 75% preference for garments negotiated under the Sri Lanka-India FTA. This preference means that during 2003/04, 2004/05 and 2005/06 Indian preferential *ad valorem* tariffs have been 12%, 5%, and 3.75% , and for garments subject to specific tariffs the tariffs for Sri Lanka are 25% of the MFN tariff. In 2003/04, the *ad valorem* equivalent for Sri Lanka of the Indian specific tariff on a \$4 shirt would have been about 12%. As Sri Lankan exporters have not been competing in India with these substantial preferences, the paper suggests that it would probably also be difficult for Bangladesh RMG exporters to compete there, even if the protective umbrella of India’s specific tariffs continues to keep out suppliers in the rest of the world.
- These likely difficulties of competing in India are compounded by the absence of a competitive low cost textile industry in Bangladesh, more so for fabrics than for yarns. This means that RMG firms exporting to India would have to deal with the usual delays and difficulties of international procurement of their textile inputs, whereas the Indian firms with which they would be competing

would in general obtain their inputs at highly competitive prices nearby in the domestic Indian market.

- In this regard, the potential Bangladesh RMG exporters would need to satisfy whatever rules of origin would be agreed under the FTA. Under SAPTA, the origin rule for Bangladesh is minimum domestic value added of 30%, but for many RMG products this could be difficult to meet unless some of the inputs are purchased in another SAPTA country e.g. India. If that turns out to be the case, it would be crucial to ensure fast and low cost transport and Customs clearance of the textile inputs obtained from India, preferably over the land border. Otherwise, if costs are high and there are unpredictable delays, Indian importers will be deterred from ordering garments in Bangladesh rather than in India.
- The paper also points out that if the Indian RMG market were to be opened preferentially to Bangladesh exporters on a free trade basis, and Bangladesh exporters were able to take advantage of the opportunity, it is likely that some of the RMG exports that go to India will be diverted from other markets. Hence, not all of the increase in RMG to India would represent a net increase in total Bangladesh RMG exports.
- The RMG market in India is far larger and more diversified than RMG production in Bangladesh. Even so, because of the importance of product differentiation in final consumer goods like garments-style, fashion, brands etc-some Bangladesh producers might be able to find market niches in India if they are able to link into strong Indian marketing organizations. However the reverse is also the case, and under an FTA with India, RMG exports from India to Bangladesh based on these considerations might well exceed Bangladesh RMG exports to India. An indication that this could happen is that during 2003/04 Bangladesh RMG imports from India were just over \$5 million⁷³. These were mainly cotton trousers and shirts which were being imported over an 85.5% tariff. The paper points out that if RMG imports from India were profitable despite such an extremely high tariff, they would be likely to expand very substantially with a zero tariff under an FTA. This would be especially likely if the Bangladesh textile sector were excluded from the FTA by the use of a negative list, because Bangladesh garment producers selling domestically would then continue to be burdened by much higher textile input costs than their Indian competitors.

Agricultural, fish, livestock and processed food and drink products During 2003/04 exports of these products from India to Bangladesh were \$731 million⁷⁴, but the reverse trade was tiny, just under \$29 million⁷⁵. Of this, approximately \$20 million was raw jute, Hilsa fish (\$5 million), betel and some other nuts (\$2.2 million) and the rest consisted of very small volumes of frozen shrimp and fruit drinks. Once again it is natural to ask whether these almost negligible recorded export levels and their persistent failure to grow can be explained by restrictive Indian import policies. As noted in section 3 and discussed in more detail in the World Bank trade policy *Overview* report, these policies in fact have been and remain much more protective than industrial protection policies. In particular:

- Import of the main foodgrains is still monopolized by parastatals, and some grains and powdered milk imports are subject to tariff rate quotas
- Tariffs on these “agricultural” products were excluded from the tariff reduction program which started in 2002/03 and –except for system of specific duties protecting the T&C sector–remain much higher than industrial tariffs. At present the generally applied tariff is 30%, but tariffs on many products are much higher, so the unweighted average tariff is around 40%.

Does this mean that there would be substantial export opportunities for Bangladesh in India if under an FTA, India were to remove its import restrictions and tariffs for Bangladesh while keeping them

⁷³ Ibid pp 27-32

⁷⁴ HS 01-24 plus raw cotton exports

⁷⁵ HS 01-24 plus raw jute imports

in force for the rest of the world? A thorough answer to this question would require updating and extending earlier studies of the relation of actual prices in both countries to world prices. However, there are a number of reasons for thinking that such studies would find quite limited export opportunities in India for Bangladesh exporters.

Firstly, as is the case of the textiles and clothing sector, the protection policies for some major Indian agricultural and other primary products can be characterized as “just in case” policies. That is, domestic prices are typically close to or even below world prices, but high protection is provided just in case there are downward swings in world prices or discounted shipments that might disrupt farmers and processors. Some obvious examples are for products which are regularly or periodically exported. For example (Table 7.2):

Table 7.2: Indian protection policies for some major exported commodities

	<i>Tariff and NTBs in India 2004/05</i>	<i>Total exports 2003/04 \$ million</i>	<i>Exports to Bangladesh 2003/04 \$ million</i>
Rice	87.2%+STE	907	197
Wheat	70% or 80% + STE	520	196
Maize	15% or 50% (TRQ)	77	36
Sugar	60% +NTB	264	32
Tea	100%	338	1
Coffee	100%	162	0
Onions	30%	156	62

Notes: STE=State Trading Enterprise= import monopoly of Food Corporation of India (FCI). TRQ=Tariff Rate Quota i.e. 15% tariff for a specified quantity of imports, 50% tariff for imports in excess of the quota. NTB=Non Tariff Barrier. For sugar this refers to the application of the Essential Commodities Act to sugar imports and to government surveillance of imports. See discussion in the project case study of the sugar industry⁷⁶

In recent years Indian rice and wheat exports have been heavily subsidized in order to cover the difference between domestic procurement prices and prevailing world market export prices. However owing to international and domestic transport costs, cif prices are much higher than fob prices, and domestic procurement and wholesale prices have typically exceeded the former –thus necessitating subsidies if there are to be exports-but have usually been below or only slightly above cif prices, and cif prices plus internal transport costs at inland Indian domestic markets. In any case, domestic prices have been far below the theoretical landed cost of imported rice and wheat were they to pay India’s prohibitive tariffs. These tariffs therefore are essentially supplements to FCI’s import monopoly over these and other food grains⁷⁷, and would be reduced with special exemptions if ever the government decided to allow some imports. Domestic prices of maize and other coarse grains have also typically been within their fob-cif bands i.e. above fob prices but lower than cif import prices in most years. Similarly, domestic prices of tea and coffee have not been very different from export prices; in fact, in the case of tea, traders who sell in both export and the domestic market buy the tea at the same auctions, so the expectation is that at this level domestic prices for given qualities would be about equal. Finally, onion prices in India are highly sensitive politically, and onion exports are subject to export controls, with the result that domestic onion prices are generally well below export prices. All this suggests that there would be limited prospect for

⁷⁶ Garry Pursell, 2004, December. *Free Trade Between India and Bangladesh? A Case Study of the Sugar Industry.*

⁷⁷ All food grains except maize and barley

exports of these products from Bangladesh to India with an FTA, certainly not in the case of rice, wheat, coarse grains, sugar and onions which Bangladesh is importing from India on a fairly large scale.

Secondly, of Bangladesh's principal primary and processed food exports—frozen shrimp, raw jute, fish, tea, vegetables, and tobacco—all except raw jute are also exported on a much larger scale by India (see Table 7.4). In 2003/04 Indian imports of shrimp and fish from Bangladesh were minimal despite a relatively low 15% tariff resulting from a 50% SAPTA preference, and imports of vegetables and tobacco were zero. This again suggests that domestic prices in India are probably close to, or not far above export prices, probably leaving few opportunities for Bangladesh exporters even if an FTA were to cut the Indian tariffs they face to zero.

Thirdly, as noted previously, in the project price surveys⁷⁸, of 14 agricultural and processed food products for which Indian and Bangladesh prices were compared, only one had a lower retail prices in Bangladesh, and only two had lower wholesale prices.

Table 7.3: Some agricultural products and processed foods: comparisons of prices and tariffs in India and Bangladesh

	<i>Ratio of Bangladesh price to Indian price</i>		<i>Indian tariff 2004/05 & NTB</i>	<i>Bangladesh tariff 2003/04</i>
	Retail	Wholesale	%	%
Rice	1.77	1.48	87.2+STE	7.5
Wheat	1.15	n.a.	70 or 80 + STE	7.5
Apple	2.09	2.20	50	86
Cumin seed	2.95	n.a.	30	66.5
Grapes	1.60	1.52	40	86
Lentils	1.23	0.89	30	11
Mango	4.74	5.12	30	86
Onion	2.39	2.74	30	26.5
Red dry chilly	0.85	0.78	70	26.5/49
Turmeric	1.26	1.32	87.2	49/66.5
Soya oil	1.10	1.20	45	7.5
Mustard oil	1.05	1.10	85	7.5
Milk powder	3.68	n.a.	15 or 60 (TRQ)	63.25 +NTB
Sugar	1.47	1.85	60+ NTB	98.4

Although there are large margins of error in these price comparisons⁷⁹, they are broadly consistent with what is known about the relation between past studies of Indian agriculture which have quantified the prevalence of tariff redundancy in rice⁸⁰, wheat and sugar. In addition, these comparisons also suggest the likely existence of tariff redundancy in apples, cumin seeds, grapes, mangoes, onions, and milk powder, because the excess of Bangladesh prices over Indian prices in these cases is too large to be explained by

⁷⁸ Das, Samantak et al (op cit)

⁷⁹ Among others, the observed prices are affected by many factors, including quality, specification, type of retail or wholesale outlet, location, and seasonal influences.

⁸⁰ The considerable excess of Bangladesh rice prices over Indian prices in the surveys summarized in the NCAER paper is puzzling, since there were substantial exports of rice from India to Bangladesh at the time of the survey. One of a number of possible explanations is that retail and wholesale rice prices in West Bengal (where the Indian survey was carried out) were depressed by local supply surpluses, whereas the export prices for Bangladesh were based on procurement prices in the surplus areas of north-west India. These were then subsidized to bring them down to whatever was needed to undercut import prices that Bangladesh importers might otherwise have paid for rice from Thailand or other exporting countries.

the excess of Bangladesh tariffs over Indian tariffs. Tariff redundancy might also explain lower prices in India than Bangladesh for soya oil, mustard oil and turmeric despite much higher Indian tariffs than Bangladesh tariffs. Only two comparisons –for red chillies and lentils-suggest some *prima facie* possibility of exports from Bangladesh to India under an FTA.

Bangladesh's secondary exports So far the prospects for Bangladesh exports to India have been considered according to product groups which are treated differently by India's import policies. Table 7.2 supplements this with some data on Bangladesh's principal secondary exports, which usually account for about 20% of its total exports. Exports of the principal 28 products and product groups during 2002/03 as reported by the Bangladesh Export Promotion Bureau, are given in the first column, and data on Indian imports, exports and tariffs in the adjacent columns. Note the following:

- Total exports of the 26 products in 2002/03 were approximately \$1.4 billion, but only \$51 million of this total -3.6%-were exports to India⁸¹
- Exports to India were accounted for almost entirely by four products-fertilizers, raw jute, jute manufactures, and frozen fish. Of the remaining 24 products, for 12, exports to India were zero, for 10, less than \$1 million, and 2 could not be quantified but were probably also zero or very small.
- Exports to India were zero or low even though India's preferential tariffs for most of them are very low. In 2005/06 India's tariffs on 22 of the products were 15% or less, and most were below 10%. Only 6 of the products were subject to high or relatively high tariffs in India: tea (100%), vegetables, tobacco, and cigarettes (30%) and textile fabrics and terry towels (both subject to specific duties)
- India is also exporting 21 of the 28 products, in most cases in much larger volumes than Bangladesh.

These observations suggest that the prospects for exporting these products to India under an FTA are quite limited. This is because (1) the Indian tariffs on the products that are currently being exported to India in non-negligible quantities-fertilizers and raw jute- are zero and 2.5%, so an FTA would make little difference; (2) exports of the other products to India are zero or negligible despite low Indian preferential tariffs in most cases (sports footwear and ceramic tableware 3.75%, tents 7.5%); (3) with only five exceptions, exports would have to compete in India with Indian firms that are exporting themselves and are likely to be highly competitive in their domestic markets. This leaves five products which are not being exported by India in which Bangladesh exporters conceivably might have better prospects in the Indian market under an FTA viz caps (headgear), tents, ceramic tableware, camera parts, and golf shafts. However, the advantage for these products of an FTA over the situation in 2005/06, would be quite limited in view of the already low 2005/06 preferential tariffs (respectively 15%, 7.5%, 3.75%, 7.5%, and 15%)

Summary: The very low level and slow growth of Bangladesh's exports to India is not primarily attributable to restrictive import policies in India. Indian tariffs on industrial goods have fallen dramatically in the past three years and are now at historically low levels, and even lower on many products on which India has given large numbers of substantial preferences to Bangladesh under SAPTA. Important exceptions to these developments are textiles and clothing, where many fabrics and garments are protected by specific duties, and "agriculture" (understood in the broad WTO sense to include to also include fish and livestock products and processed foods) where there are still government import monopolies and other NTBs, and tariffs are still vary from high to prohibitive. But there is a great deal of tariff redundancy in both these two sectors, with domestic prices of most T&C products (including ready

⁸¹ Exports to India are from the Indian import statistics and are given for Indian fiscal 2002/03 for comparability with the Bangladesh EPB's 2002/03 export data. There were no major changes in India's imports of these products during the Indian fiscal 2003/04.

made garments) and of many agricultural products are at or even below international prices. In addition, in the industrial sector, many more Indian industries than in the past are exporting, and domestic markets are increasingly competitive. This means that the prospects for the expansion of Bangladesh exports to India are at present quite limited, and would remain modest even if Bangladesh from an FTA with India under which Bangladesh exporters would have duty free access to the Indian market, while the present tariffs and other restrictions on imports into India from the rest of the world would remain the same.

Table 7.4: Bangladesh's principal exports other than garments: Indian exports, imports and tariffs

Bdesh		Bangladesh exports during 2002/03		Indian imports	Indian exports	Indian tariff 2005/06	
HS code		Total	To India	2003/04	2003/04	MFN	Pref for Bdesh
		\$ million	\$ million	\$ million	\$ million	%	%
030613	Shrimp	297.0	0.3	61.7	836	30	15
4107	Leather (bovine)	191.2	-	1.5	135	15	13.5
5310??	Jute manufactures	133.7	3.3	1.1	65	15	6
5307/5607	Jute yarn/twine	122.8	0.1	1.0	76	15	7.5, 6.0
5303	Raw jute	82.4	20.4	20.5	1	5	2.5
6504	Cap	81.7	0.0	0.0	1	15	15
310210	Urea#	78.6	25.3	102.8	-	0	0
281420	Anhydrous ammonia#			238.8	3	5	0
8712	Bicycles	52.5	-	0.0	44	15	15
630619	Tent	46.8	0.1	0.0	2	15	7.5
6404/6405	Leather footwear	35.1	0.0	0.0	557	15	7.5
5802	Terry towel	29.6	0.0	0.2	12	15+S	6+S
630710	Shop towel	26.9	-	0.2	22	15	7.5
0303	Frozen fish	24.8	1.9	12.4	124	30	15
691110	Ceramic tableware	18.8	0.0	0.1	3	15	3.75
900691	Camera parts	17.3	-	0.3	1	15	7.5
49	Printed materials	16.6	0.1	26.6	95	0 or 15	0 or 7.5
27101950	Furnace oil	16.2	-	-	185	10	10
Various	Textile fabrics	15.2	?	818.0	4186	15+S	6 or 7.5+S
2710	Naphtha	15.0	-	-	861	5 or 10	5 or 10
090240	Bulk tea	13.7	0.0	22.6	236	100	100
07	Vegetables	13.2	0.0	18.8	329	30	30
950631	Golf shaft	10.3	-	0.1	0	15	15
240220	Cigarettes	10.3	-	0.8	29	30	30
39232910	PVC bags	9.9	-	0.1	13	15	7.5
64	Sports footwear	9.0	-	37.0	768	15	3.75
85392190	Indicator lamp	7.2	-	0.2	5	15	6
2401	Tobacco	6.7	-	0.4	174	30	30
Various	Handicrafts	5.9	?	?	?	15	7.5 ?

Notes: Bangladesh total exports in 2002/03 from Export Promotion Bureau website at www.epbbd.com EPB treats sales of somelocally produced intermediate to Bangladesh exporters as "exports" : these have been excluded from this table (e.g. zippers and acrylic yarn). # "Chemical fertilizer" exports in the EPB statistics are urea and "anhydrous ammonia" in the Indian import statistics (Table 7.1) HS codes are not given for some of the product groups so in these cases the comparisons with the Indian trade statistics are approximations, and could not be made in the case of "handicrafts" Indian tariffs from Goyal *Easy Reference Customs Tariff 2005-06*. Indian exports and imports in 2003/04 and Bangladesh export to India in 2002/03 from DGFT trade database. 0.0=<\$0.5 million, -=zero Geater of ad valorem or a specific duty indicated by ad valorem duty rate and +S

Chapter 8: Informal and illegal trade: dimensions, trends, composition, and the role of domestic indirect taxes

Ever since Bangladesh's independence there has been a substantial informal unrecorded trade across the India-Bangladesh land borders, and a number of studies both in Bangladesh and in India have dealt with different aspects of it.⁸² Much of this trade is quasi legal and is best characterized as "informal" rather than illegal, because there is wide participation by local people in the border areas, the trade generally bypasses Customs posts, and because –as S.K. Chaudhuri's classic study noted–"the field operators generally operate *in liaison* with the anti-smuggling enforcement agencies".⁸³ Informal trade of this kind usually involving large numbers of local people individually transporting small quantities-often just as head loads or by bicycle rickshaw-and in Bangladesh is sometimes called "bootleg" smuggling. At the other extreme there is trade which goes in larger quantities-mostly by truck-through the formal legal Customs and other channels, but which involves explicitly illegal practices such as underinvoicing, misclassification and bribery of Customs and other officials, and which in Bangladesh is sometimes called "technical" smuggling.

While these two types of smuggling are conceptually distinct, the various studies also recognise that there is continuum of smuggling activities between them, involving for example medium and larger scale operators using trucks or boats which may cross the border at Customs posts without being recorded, or in regions where there are no Customs posts. In addition, although the goods may be carried across the border in small quantities by large numbers of people, trucking to the border areas-often from distant parts of India-and storage there-is frequently organized by medium size and large traders who are also exporting to Bangladesh through formal channels. The inevitable absence of a clear demarcation between these kinds of smuggling has been a problem for the various studies which have attempted to quantify the level and composition of this trade through systematic interviews of "knowledgeable persons" in known smuggling centres. With the exception of some separate estimates of "technical smuggling" into Bangladesh in the study prepared as part of this project, all the past studies have focussed on "bootleg" smuggling and have reported accordingly, but it is unlikely that the "knowledgeable persons" responding were distinguishing between these two different smuggling routes. Hence, among the many other obvious difficulties of obtaining some rough quantification of this trade, the estimates of "bootleg" smuggling-especially in the region of the principal Petrapole-Benapole land border crossing-are likely to be picking up the results of "technical" smuggling as well. This in turn means that adding separate estimates of "technical" smuggling to estimates of "bootleg" smuggling will overstate the total value of unrecorded trade.

All the literature on the India-Bangladesh unrecorded trade confirms that this trade is essentially one-way, from India to Bangladesh. Omitting gold, silver and currency which is imported into India in part to pay for Indian goods, the 1994 NCAER survey estimated Bangladesh to India unrecorded trade at only about \$10 million⁸⁴, compared with an India to Bangladesh estimate of \$371 million. In order to update previous studies on the latter, under this project quick surveys were carried out during April-May 2002 in five smuggling-prone zones along Bangladesh's western borders with India, and in three zones in its north and eastern borders with India. Based on the opinions of police, security forces and others, and on earlier more complete surveys, these eight zones were considered to account for 77% of the total of

⁸² Seven of these studies are briefly reviewed in the project paper on informal trade. *India-Bangladesh Informal Trade: Findings on Bangladesh Imports from India*. Draft mimeo, January 2005.

⁸³ Chaudhuri, S.K. (NCAER) 1995. *Cross Border Trade Between India and Bangladesh*, p.27. Italics added. The report continues: "Once in a while, either due to a breach of the understanding or to demonstrate efficiency or agility of the law enforcing staff (to meet anti-smuggling targets, if any), some seizures are stage managed and the petty operators bear the consequences".

⁸⁴ Ibid p. 53, Table 3.5

bootleg imports. In addition, a separate study was made of “technical” smuggling, based on interviews with importers, Customs agents and officials and others at Benapole and Chittagong, as well as a sample of Bangladesh Customs intelligence inspections of shipments at Benapole between January and November 2002.

These estimates of “bootleg” smuggling were then compared with similar 1998 estimates for the same five western zones in a study by Rahman and Razzaque⁸⁵. For this synthesis, this comparison has been taken back further to include the results of the Chaudhuri (NCAER) study, which was based on field surveys in India during July and August 1994, and which also focussed on bootleg smuggling.⁸⁶ This is combined below with some findings from some of the other project consultant studies to comment on the total size of, and trends in this trade and its commodity composition. This is followed by a discussion of the role of domestic indirect taxes in the smuggling trade, which has largely been ignored in previous work, and finally by a summary of policy and other reforms which would affect smuggling and which would seem to be in the economic interests of both countries, whether or not they participate in an FTA.

Size According to the 2002 surveys and some very approximate extrapolations from them, Bangladesh’s smuggled imports from India during 2002/03 were approximately \$500 million, or about 40% of recorded imports from India, and approximately 30% of total imports (recorded plus smuggled) from India (Table 8.1). The total value of goods imported by “technical” smuggling- underinvoicing, misdeclarations and other illegal practices at Customs- is estimated to exceed total “bootleg” smuggling by a substantial margin, and most of the “technical” smuggling occurs at the land border. Between them, ‘bootleg’ and “technical” smuggling at the land borders add about 70% to total land border imports (Table 8.2) but appear to be much less prevalent in the sea and air trade. Based on surveys at Chittagong which asked about underinvoicing and misdeclaration practices, total technical smuggling of imports from India by sea and air was about 17% of the total recorded value of this trade, compared to 32% of the total recorded value of imports by the land border. These shares would be somewhat lower if it were possible to allocate “back-to-back L/C” imports (i.e. duty free imports of inputs used by Bangladesh exporters) between the land border and the sea trade, but these imports are not recorded by NBR and the available estimates are from Bangladesh Bank statistics on letters of credit which do not distinguish these two routes.

For many reasons that are emphasized in the 2002 survey reports, the estimates of “bootleg” smuggling and even more so the estimates of “technical” smuggling are very rough approximations at best and subject to wide margins of error. Indications of the possible size of these errors is apparent from the project study on trade financing and the case study of the sugar industry. In the first study, a by-product of interviews with “knowledgeable persons” in India on India-Bangladesh trade financing gave estimates of the value of live animals and some major smuggled commodities which were much larger than the estimates based on the surveys in Bangladesh:

These estimates in the Goyal study were based on the opinions of relatively few people and may not be reliable, since the focus of the study was on financing and they were not systematically checked against the estimates of other informed people. However, Goyal’s estimate for sugar smuggling is roughly consistent with the sugar case study, which estimates sugar smuggling at between \$170 million and \$215 million in 2001/02 and from \$100 million to \$127 million in 2002/03. A partial explanation for these discrepancies may be that Goyal’s and the sugar study estimates were including “technical” as well as

⁸⁵ Rahman, A. and Razzaque. 1998. *Informal Border Trade between Bangladesh and India: An Empirical Study in Selected Areas*. The Asia Foundation.

⁸⁶ The 2002 study is the first documented attempt to estimate the size and scope of “technical” smuggling. There are a number of other estimates of the approximate total size of technical smuggling, but none of them explain in detail how the estimates are arrived at.

“bootleg” smuggling, whereas the Bangladesh surveys which distinguish individual products are in principle for “bootleg” smuggling only. Even so, the resulting discrepancy in the estimate of total land border smuggling is very large: for example, the total discrepancy of just these five commodities as reported in Goyal’s study, would about double the survey-based total (bootleg+technical) estimate for 2002/03 from \$422 million to \$831 million, and assuming a smaller discrepancy for sugar of \$100 million, still increases the total survey based estimate by about 40%, from \$422 million to \$708 million. These very large differences underline the importance of coordinated contemporaneous surveys on both sides of the border with iteration between the survey teams involved to explore and narrow down discrepancies. Unfortunately, all the studies which have aimed to quantify cross border smuggling—including the 2002 Bangladesh survey, the 1998 Bangladesh surveys reported by Rahman and Razzaque, and the 1994 NCAER survey –have all faced time and resource constraints which would have been needed for this kind of coordination, and therefore are based solely on the analysis of survey results dealing with imports in the case of the Bangladesh surveys, and on exports in the case of the 1994 NCAER survey in India⁸⁷.

	<i>2002 Bangladesh survey \$ US million</i>	<i>Goyal: trade financing report \$US million</i>	<i>Difference \$US million</i>
Live animals (mainly cows & buffaloes)	100	222	+122
Sugar	27	250	+ 223
Rice	9	30	+ 21
Wheat	14	48	+ 34
Onions	1	10	+ 9
TOTAL	151	560	+ 409

Trends Table 8.3 compares the estimates of “bootleg” smuggling from the three surveys mentioned above and compares these with the Bangladesh statistics of recorded imports from India for the same years (for comparability excluding back- to- back LC imports in all years since they are not available for FY 1995). According to these estimates, during the 8 years total bootleg smuggling declined both in absolute terms and relative to total recorded imports from India, the latter from 58% of total imports in FY 1995 to 20% of total imports, and from 51% of total imports by the land border in FY 1998 to 41% of land border imports in FY 2003. It might be tempting to conclude from these statistics that smuggling from India has been declining and to link the apparent decline to import liberalization in Bangladesh, in particular to the steady reduction of Customs duties during the same period. However, for a number of reasons this would be a hazardous generalization:

- The discrepancies discussed above between the Bangladesh 2002 survey-based estimates of smuggled cattle and some major commodities, and alternative estimates from the Indian side, are very large and would need to be checked before generalizing about trends
- The 2002 Bangladesh survey is the only attempt to quantify “technical” smuggling, and without estimates for earlier years no generalizations about trends are possible. In this regard it is relevant

⁸⁷ This study used information provided by BIDS on smuggling centres in Bangladesh to help choose the outward smuggling centres in India to be surveyed, but the smuggling estimates were entirely based on interviews in India. The goods being smuggled were valued at prevailing prices in these regions, which were considerably lower than the prices at which the goods were sold on the Bangladesh side. Ideally, these valuations would need to be adjusted to compare the NCAER smuggling estimates with estimates made in Bangladesh. The NCAER study had a separate component dealing with underinvoicing through the comparison of the Indian and Bangladesh trade statistics, but concluded (p.99) that statistical errors and other factors (including especially overinvoicing on the Indian side to benefit from Indian export incentives) were too pervasive to allow realistic estimates. The study (pp 18-19) also did not attempt to deal with misclassification, understatement of weights and quantities and similar practices at Customs.

to note that trends in “technical” and “bootleg” smuggling are probably related. For example, if smuggling through underinvoicing and other means through the legal route becomes more difficult, it is likely that some smuggling will be diverted to “bootleg” routes, and vice versa. Despite the introduction of pre-shipment inspection in India for Indian exports to Bangladesh and other measures, the consultant studies do not indicate that the legal route has become markedly more rigorous, at least at the land borders.

- According to the sugar industry case study, sugar smuggling increased between FY 1995 and FY 2002 : it only declined sharply after imports via the land border were banned in 2003, suggesting that large quantities of sugar were previously being imported illegally under the cover of legal imports.
- Finally, as discussed previously, since the mid-1990s in some key respects Bangladesh’s import policies have become more, not less distortive. Changes in tariffs seem to be related to smuggling incentives in the following ways, and overall it is plausible that the net incentive to smuggle may have increased rather than decreased:
 - Including para-tariffs, Bangladesh’s protection rates on a wide range of locally produced consumer goods have gone up, many to very high levels, increasing the incentive to smuggle, especially at Customs by underinvoicing, misclassification and other practices
 - Although Bangladesh’s longstanding ban on the import of textile fabrics was recently removed, textile fabric protective import duties remain very high and continue to provide a strong motive for fabric smuggling from India
 - Tariffs on a few important products which are smuggled on a large scale have remained low during the period (e.g. rice and wheat) so this incentive to smuggle has not greatly changed.
 - Tariffs on most industrial raw materials, parts and components and machines have declined, reducing the incentive to smuggle them by both the “technical” and bootleg routes.
 - However, the increasing bifurcation of protection rates, with very high tariffs (including para-tariffs) on locally produced consumer goods and low tariffs on raw materials and intermediates, will have increased the incentive and potential for “technical” smuggling through false documentation i.e. falsifying the description of products so that they are misclassified as products subject to low rather than high tariffs
 - The incentives for “ technical” smuggling through under declaration of the quantities of duty free shipments of inputs for exporters—especially yarns, fabrics, dyes and other inputs for use by RMG exporters- has probably not greatly changed and remains considerable.

Composition According to the 2002 surveys, the value of “bootleg” smuggling was divided as follows:

	<i>% of total</i>	
Cows and buffaloes	43	
Agricultural products	14	Of which 90% rice, wheat, pulses & timber
Processed foods	17	Of which 88% sugar
Textiles	16	Of which sarees 63%
All other	10	43 products

These shares were roughly the same as in the 1998 survey, except for an increase in the share of processed foods (nearly all sugar) and a smaller share of textiles. The products being smuggled

correspond fairly closely to the products mentioned in NCAER's survey of exporters in Kolkata⁸⁸. In this survey, for products which were the same or similar to those they were exporting, the exporters were asked whether the "source of entry" into Bangladesh was (1) legal only (2) illegal only or (3) both legal and illegal. For 52 products, the responses divided as follows⁸⁹:

Type of product	"Source of entry"	
	Legal only (no. of products)	Both legal and illegal (no. of products)
Agricultural	4	10
Processed foods	1	3
Manufactured	20	13
Mineral (bauxite)	1	0
TOTAL	26	26

Since the question just referred to the entry channel, "illegal" is best interpreted as bootleg smuggling i.e. exports that were going over the border and bypassing the Customs posts. However, underinvoicing and similar practices could have been going on when the products were exported by the legal route.

There is very limited information on the commodity composition of "technical" smuggling. Some indication is provided by the diverse set of agricultural and industrial products included in 52 shipments that were inspected by Bangladesh Customs Intelligence at Benapole during January –November 2002 and found to have under-declared the weight or the number of items in the shipment (Table 8.4). Most of these shipments were of industrial products-only 8 of the 42 (4 of rice, 2 of spices, one each of coconuts and lentils) were agricultural products. Judged by the number of separate shipments, false declarations were most common for paper board and paper products, followed by sanitary ware. Under-declarations of weight or quantity varied from 10% to 67% and averaged about 30%, but values were not provided in the data set, so it is not possible to infer anything about the ranking of different commodities in terms of the value of technical smuggling.

The third column of Table 8.4 shows the import duty rates to which these products were (or should have been) subject during FY 2003. The first rate is the protective tariff including the protection of the para-tariffs, and the second is the total rate the importer would have had to pay inclusive of VAT. In two cases (rice and lentils) the import duty rate was very low by Bangladesh standards (7.5%) and both were exempt from VAT, but the import duty saving was probably substantial due to the fairly large quantities involved, in the case of rice (four consignments) 734 tons declared as 410 tons, and in the case of lentils 130 tons declared as 100 tons. However all the other tariffs were much higher: mostly 35.5% before VAT and 55.9% with VAT included. Tariffs at these levels combined with under declaration of quantities (e.g. a shipment of stainless steel kitchen ware- declared quantity 12 tons, assessed quantity 16 tons) provide large financial savings if they are not prevented. Another example is sanitary ware which accounts for 5 of the 52 consignments in the data set, with a total of 7333 pieces declared as 4100 pieces, and very high tariffs in 2002/03 –inclusive of VAT 71.1% (plastic sanitary ware) and 132.1% (ceramic sanitary ware). Sanitary ware products (see Fig 8.5) are a few of many mostly final consumer goods for which protective tariffs were sharply increased after 1998/99, in order to encourage and protect local producers, and this example demonstrates one of the consequences of these policies at Customs and on smuggling incentives and the volumes of goods being smuggled.

⁸⁸ 17 products mentioned as being smuggled by the exporters were also on the list of smuggled products turned up by the Bangladesh survey. 9 products were not, however: 3 agricultural, 1 processed food, and 5 manufactures. The NCAER survey did not attempt to estimate quantities or values of the smuggled goods.

⁸⁹ Das, Samantak et al, op.cit Table A.2

Smuggling and domestic indirect taxes. The various past studies of informal and illegal trade between India and Bangladesh, pay little or no attention to domestic indirect taxes i.e. in India, the central excise tax and the central and state sales taxes (the latter recently replaced in most states by a state VAT), and the VAT in Bangladesh. Yet these are very important for understanding the nature and modalities of the trade and its economic impact. In both countries agricultural products, livestock and fish are exempt from these taxes, and this is presumably one of a number of reasons why they dominate the estimates of “bootleg” smuggling. But manufactured products in India, including most processed foods, are subject to indirect taxes which are generally at least 20% (the 16% central excise tax plus sales tax or state VAT). If these products are purchased in India at retail, wholesale or even from the producing factories, the purchase prices will (or should in principle) include these taxes. Hence, if the goods are then smuggled over the border by the bootleg route, the indirect taxes are a kind of *de facto* export tax under which the Indian central government and an Indian state government (e.g. West Bengal) in effect taxes the eventual buyers in Bangladesh. Alternatively, since the smuggled goods presumably escape paying the VAT in Bangladesh, this amounts to a transfer from the Bangladesh government to the central and state government in India, insofar as the smuggled goods substitute for locally produced or legitimately imported goods that would have been subject to the Bangladesh VAT.

However, as noted above, if Indian manufactured goods are exported to Bangladesh by the legal route, the cost of the goods to the exporter does not include these domestic indirect taxes, which means that the cost to (say) an exporting trader will be at least 17% less than the cost of the same goods purchased domestically, in addition to which the cost of the goods is further reduced by duty drawback, DEPB or one of the other mechanisms by which exporters are either exempted from, or compensated for, import duties which increase the costs of their raw material inputs. On the other hand, from the perspective of a Bangladesh importer choosing between the formal legal route and the bootleg route, the formal route involves Bangladesh Customs duties including the Bangladesh VAT and the associated transport and transaction costs. Hence preferences for the formal route will be influenced by:

- The level of Bangladesh protective tariffs. If these are low or the products exported are exempt (as is the case for inputs and equipment used by Bangladesh exporters) the formal route is obviously preferable, but if the tariffs are high –as is the case for most Bangladesh manufactured consumer goods–there will be a strong incentive to ship by bootleg routes
- The rigor of Customs administration, especially on the Bangladesh side. If high import duties can be reduced or evaded by misclassification, underinvoicing and similar practices and if the bribes and other side payments and the risk of penalties do not absorb too much of the perceived benefits, the attractiveness of the bootleg route will be reduced and will be substituted by “technical” smuggling in the legal route.
- The nature of the goods and VAT administration in Bangladesh. The VAT charged on imported goods would not be a deterrent to importing if VAT administration in Bangladesh were rigorous and if it covered all products and all stages of production and distribution. In that case the VAT charged on importing could be offset against VAT liabilities at subsequent points in the production or distribution chain and would not be a disadvantage for Bangladesh importers using the formal route as against importing by the bootleg route, where there would be no documented VAT payment to credit against subsequent transactions. In practice the Bangladesh VAT is reported to effectively cover formal manufacturing activities but does not effectively extend to wholesale and retail distribution. In that case the VAT would not constitute a disadvantage (or at least not a substantial disadvantage) for importing intermediate raw materials and components from India by the formal route, but is likely to be a substantial disadvantage for the import of final consumer goods (including replacement parts of consumer durables) by the formal route. Hence evasion of the Bangladesh VAT on imports of consumer goods is an independent extra motive to either smuggle by the bootleg route or participate in underinvoicing and other evasion practices using the legal route. This is even more the case if the Bangladesh “supplementary

duty” is used to raise Bangladesh protection rates, since both duties are included in the base for the VAT⁹⁰.

- The state of the infrastructure (roads, storage, technical and administrative capabilities etc) on both the Indian side and the Bangladesh side at the border Customs posts, and the resulting time and transaction costs associated with the use of these formal routes. It is widely recognized, both in India and Bangladesh, that there are serious deficiencies on all of these counts at the land Customs posts, most importantly at the Petrapole-Benapole crossing. As already noted, a major problem on the Bangladesh side is that all except a few of its Customs posts are restricted to clearing a very limited set of products. This means that exporters or potential Indian exporters of the many products not on this list in most areas along the land borders have to choose between shipping the goods over long distances to the few places where legal imports are authorized by Bangladesh, or organizing for them to be shipped across the border by the illegal bootleg route

Some conclusions The above discussion suggests a number of policy and other reforms that would serve the economic interests of both India and Bangladesh by channelling trade away from the bootleg routes to the formal routes and by reducing the incentives and scope for corrupt practices in the formal routes

- Bangladesh would bring down its presently very high tariffs protecting import substitution industries by reversing the policies under which protection rates have been drastically increased over the past 6 or 7 years by the use of para-tariffs on top of Customs duties
- Both countries would improve the infrastructure –physical and administrative-at their land border Customs posts. This would need to be done in a coordinated way-there would no point if the infrastructure were improved on one side of the border but bottlenecks were to remain or even increase on the other side of the border.
- Both countries would continue and accelerate efforts to streamline and improve the administrative structures that affect land border trade, especially Customs administration. For Customs the purposes would be to speed up and simplify Customs clearance and to reduce the incentives for, and scope of corrupt practices. The present pre-shipment inspection system at present operating in India on behalf of Bangladesh Customs would be part of this effort
- The administrative reforms would include expanding the facilities and the Customs clearance powers available at Bangladesh’s smaller land border Customs posts
- Bangladesh would continue to expand the effective coverage and improve the administration of its VAT system

For Bangladesh these reforms would reduce the incentives for imports from India to come by the bootleg route, under which a substantial share of the economic rents are collected on the Indian side, both in the form of smugglers’ margins and Indian indirect taxes included in the purchase prices of the goods in India. The trade diverted to the formal channel would provide Customs revenue, and this would be higher if administrative and other reforms reduce the scope for corrupt practices. Better infrastructure, faster clearance times and reduced transaction costs would also improve the prospects of Bangladesh exporters finding market niches in India, especially if they rely on importing inputs from India since in that case two border crossings are involved.

These reforms would also benefit India, first by reducing “black economy” activities in India associated with the bootleg border trade and the organization of “technical” through Bangladesh Customs, and secondly by improving the access of Indian exporters to the Bangladesh market.

⁹⁰ For example, with a 25% Customs duty alone the 15% VAT is 18.8% of the cif price, but if a supplementary duty of 25% is also imposed, the VAT becomes 23.4% of the cif price.

Table 8.1: Bangladesh imports from India 2002/03: recorded plus survey-based estimates of smuggled imports

	\$US million	% of total
Recorded: land border	580	34
Recorded: sea and air	535	31
Recorded: back to back LC	95	6
Total recorded imports	1210	70
Bootleg: land border	237	14
"Technical" smuggling (land)	185	11
"Technical" smuggling (sea)	90	5
Total unrecorded imports	512	30
Total imports	1722	100

Sources: recorded imports from NBR trade database, back to back LC imports from Bangladesh Bank, estimated smuggled imports from surveys during 2002.

Table 8.2: Bangladesh land border imports from India 2002/03: recorded plus survey-based estimates of smuggled imports

	\$US million	% of total
Recorded: land border	580	58
Bootleg: land border	237	24
"Technical" smuggling (land)	185	18
Total land border imports	1002	100

Sources: as for Fig 8.1

Table 8.3: Trends in estimated "bootleg" smuggled exports from India to Bangladesh

FY	Recorded	Recorded	Estimated	Estimated bootleg as	
	land	total	bootleg	% of land	% of total
	\$ million	\$ million	\$ million		
1995	n.a.	645	371	n.a.	58
1998	603	786	309	51	39
2003	580	1176	237	41	20

Notes: Back to back LC imports from India n.a. in FY 1995 & have been excluded from the FY 1998 and FY 2003 imports for consistency. Land border imports also n.a. for FY 1995." Bootleg" imports from studies mentioned in the text.

Table 8.4: Some examples of "technical smuggling": sample of consignments inspected at Benapole (January-November 2002) and found to have declared quantities less than assessed quantities

	No of consignments	Import duty rates %(Before VAT/after VAT)
Paper board and paper products	15	25.5/44.4
Sanitary ware	6	48.8/71.1 or 92.2/132.1
Marble & granite	5	25.5/44.4 or 35.5/55.9
Rice	4	7.5/7.5
Magnesium sulphide	3	35.5/55.9
Spices	2	35.5/55.9
Methi (?)	2	
Motor parts	2	25.5/44.4 or 35.5/55.9
Vushi (?)	1	
Leaf springs	1	
Acetic acid	1	35.5/55.9
Coconut	1	26/26
Stainles steel kitchen ware	1	35.5/55.9
Lentils	1	7.5/7.5
Chips (?)	1	
Plywood	1	35.5/55.9
Poultry feed	1	
Synthetic sarees	1	52.1/52.1
Medicinal herbs	1	
Assorted goods	1	
Insulator/electrical arrestor	1	
Total number of consignments	52	

Notes: The product descriptions are not precise and the HS codes and tariffs are not reported in the original data from which this table is compiled. Consequently the 2002/03 tariffs indicated in the third column may not be the same as the actual tariff rates. Blanks indicate that the product description is not sufficiently detailed to attribute a tariff. The two sets of rates for sanitary ware are respectively for plastic and ceramic sanitary ware. The inspections were undertaken by Bangladesh Customs Intelligence

Fig 8.5: Bangladesh sanitary ware tariffs FY 98 and FY 2003-2005

FY	<u>Ceramic HS 6910</u>		<u>Plastic HS 3922</u>	
	Protective	Incl	Protective	Incl
	rate %	VAT %	rate %	VAT %
1998	47.2	68.9	47.2	68.9
2003	92.2	132.1	48.8	71.1
2004	89.0	128.3	66.0	90.9
2005	64.0	98.1	59.7	83.7

Chapter 9: Trade financing, logistics and transaction costs

As part of the project, consultant studies were prepared on the financing of India-Bangladesh trade and on some aspects of its logistics. The original intention was to deal with Bangladesh exports to India as well as Indian exports to Bangladesh, but in both cases the surveys and studies only covered the latter, mainly because the volume of Bangladesh exports to India is so small that it was difficult to identify participants that could throw much light on these aspects. Ideally this work would have been a coordinated effort carried out in both countries, but for various reasons it was done only on the Indian side by Indian consultants. Despite these shortcomings, the studies have brought out some interesting aspects of these activities. The principal findings are briefly summarized below, first for trade financing, and secondly for trade logistics and transaction costs.

Trade financing

This study⁹¹ deals with the financing of Indian exports to Bangladesh-both exports by the legal route, and informal (smuggled “bootleg”) exports. It distinguishes the following principal sources of foreign exchange and mechanisms by which Bangladesh importers pay for imports from India:

- LCs issued by Bangladesh banks
- Lines of credit released by the Indian government for Bangladesh imports of Indian capital goods
- Informal hawala (also known as hundi) payment networks
- Remittances from Bangladeshis working outside South Asia (especially in the Middle East) through the hawala networks
- Remittances to Bangladesh from the large Bangladesh migrant communities living in India
- Smuggling of gold and currency (mainly Taka) into India from Bangladesh
- Illegal trafficking in narcotics, arms, stolen property and women and children from Bangladesh into and through India

The study makes a number of points about these financing mechanisms which are highly relevant for understanding the nature of the bilateral trade.

First, as regards LCs, it notes that Bangladesh government rules they are compulsory for all import consignments in excess of \$ 5000, but involve very high transaction costs. This is principally due to high charges (up to 3% of the transaction) for LC confirmation by a prime US or other developed country bank. In addition, until December 2003 Bangladesh importers were required by Bangladesh Bank to deposit compulsory margins which tied up working capital and involved a substantial extra cost as the margins generally exceeded the margins that would have been required by the banks issuing the LCs. According to the study, adding these costs to a variety of other transaction costs makes LC financing prohibitively expensive for most Bangladesh importers, so most LCs are not confirmed by prime foreign banks and therefore do not provide working capital to the Indian exporters since they cannot be discounted. In addition delivery of the goods in Bangladesh is typically taken by the importers without negotiating the LCs, so that in practice “the LC is a mere cover to move goods through the Customs”⁹². The study comments that LC costs would have declined since Bangladesh Bank’s compulsory margin requirements were dropped in December 2003, but implies that the costs are still too high for the LCs to in fact finance imports from India, and that payments and delivery of the goods are being directly negotiated between the Bangladesh buyers and the Indian suppliers without any substantive role for the compulsory LCs except as additional documentation during Customs clearance.

⁹¹ Goyal, Arun (2004, October). *Study on Financing of India-Bangladesh Trade*

⁹² Ibid p.13

This finding, that the LCs in this trade are not in practice being used for their normal function of reducing the risks and facilitating financing for both the importers and the exporters, implies that they would not be used in the trade if they were not compulsory. If this is correct, they involve non-negligible transaction costs without protecting the suppliers and importers against commercial risks such as defective shipments, non-payment, delayed payments etc.⁹³ *A priori*, this would appear to be relevant in any assessment of whether compulsory LCs are in fact an effective additional check on underinvoicing and other illegal practices at Customs in the India-Bangladesh trade.

Secondly, the study points out that the hawala networks perform much better than the formal banking system in terms of simplicity, speed, transaction costs, and reliability, and that for these reasons they are not only financing much of the informal bootleg smuggling trade from India to Bangladesh, but also substantial parts of the exports to Bangladesh that go through the legal routes. Remittances from the Bangladeshi workers in the Gulf countries and from Bangladeshi residents in India provide the foreign exchange, usually as US dollars or as Rupees in India, and Taka are provided by the Bangladesh importers. As regards imports into Bangladesh through formal Customs channels, some form of hawala payment would generally be needed to balance accounts if there is “technical” smuggling. For example, prices and quantities in a shipment as given in the shipping documents and an accompanying LC might match, but additional payments to the exporter will be needed if the quantities exceed the declared quantities or the products are different from the descriptions given in the documents.

Thirdly, the study notes that, in addition to hawala payments, informal exports from India to Bangladesh are also paid for by gold and Taka smuggled into India. According to the study, recorded Customs seizures in India of gold and currency are very small but are only “the tip of the iceberg” as the Indian Customs officials at the border avoid this kind of seizure owing to involved judicial procedures in gold and currency cases. The smuggled Taka are used to buy Rupees from informal foreign exchange traders who offer considerably more favourable Taka/Rupee rates than can be obtained from the banks, which are obliged to first convert the taka to US dollars and then to Rupees, as there is no official direct Taka/Rupee foreign exchange market. The report points out that the lack of such an official market means that remittances of the Bangladeshi immigrant community to Bangladesh (estimated at about \$260 million a year) go entirely by the informal hawala networks.

Trade logistics and transaction costs

It has long been recognized that there are serious logistical problems (congestion, delays, side-payments etc) at the land Customs stations on the India- Bangladesh border⁹⁴. In order to provide some quantitative indications of the scale of these problems, as part of this project NCAER organized surveys of exporters and transporters in the Kolkata-Petrapole region during July and August 2002. The results of these surveys are summarized and interpreted in a paper by Samantak Das and Sanjib Pohit⁹⁵. This paper first of all describes some of the infrastructure deficiencies and procedural hazards at these places, which include (at Petrapole, which is by far the best equipped) inadequate and congested roads, absence of government bonded warehouses, irregular power supplies, inadequate sanitary facilities and drinking water, prevalence of theft and other crimes, frequent strikes, prevalence of speed money, a single border gate which handles all truck and other traffic as well as individual travellers and which is wide enough for

⁹³ So called “back-to-back” LCs that finance imports of inputs needed by exporters are presumably not subject to these problems, since they have the backing of the original export LCs issued by banks in the US, Europe and other countries from which the exports have been ordered.

⁹⁴ These have been described and analysed as part of a comprehensive study of transport and logistics in the India-Nepal-Bhutan-Bangladesh sub region edited by Uma Subramanian (op cit)

⁹⁵ Das, Samantak, and Sanjib Pohit (2004). “Quantifying the Transport, Regulatory and Other Costs of Indian Overland Exports to Bangladesh”. Mimeo.

only one truck at a time to pass through. They point out that these and other deficiencies are if anything more severe at other land Customs stations, and they give the examples of Hilli and Mahadipur.

The Petrapole crossing was chosen for the survey because it handles by far the largest share of the recorded India-Bangladesh land border trade. Petrapole is on a major road 95 kilometres from Kolkata. The neighbouring town on the Bangladesh side of the border is Benapole, which in turn is linked by a highway to Jessore and Dhaka. The survey was carried out in Kolkata and Petrapole and responses were obtained from 15 transporters and 82 exporters, all engaged in the India-Bangladesh trade. The questions were framed so as to elicit the opinions of the transporters and exporters on the *excess* time and cost of transporting goods from Kolkata, clearing Indian Customs, unloading the goods on the Bangladesh side, and returning to the Indian side of the border. The excess cost and time involved was estimated by asking what each exporter or transporter considered should have been normal or reasonable, and comparing that with the actual time spent and actual expenses. In the case of congestion on the road from Kolkata to Petrapole, the “normal” time seems to have been defined as the time a truck would have taken to travel the same distance in normal conditions along an equivalent stretch of other national highways. What might have been considered “normal” or “reasonable” for activities such as the various stages of Customs clearance is more subjective, but the responses appear to have been reasonably consistent, probably because of queuing and waiting times that were about the same for everyone. The respondents were then asked to put a value on the estimated excess time they spent at the various points in the shipment and clearance process, in particular loading in Kolkata, transport from Kolkata to Petrapole, clearing Indian Customs at Petrapole, unloading in Bangladesh, and returning to the Indian side of the border. How this excess time was valued was left to them: the answers presumably mainly reflect the estimated opportunity cost of the time as they perceived it e.g. for a trucker, what could have been earned by using the truck during the “excess” time that it is tied up at Petrapole. In addition, all the respondents mentioned that as a matter of routine they pay “speed money” to police, Customs and other officials. They also experience delays in receiving export remittances, which they also attribute to slow bureaucratic processes. The perceived cost of these delays and the speed money payments⁹⁶ were then aggregated with the estimated excess time costs to give estimates of the total excess costs involved, and then these estimates were expressed as a percentage of the average value of a typical shipment. According to these calculations, the actual cost of an average shipment from Kolkata to the point of Customs clearance in Bangladesh was 12.31% of the value of the shipment, compared to an “ideal” cost of 1.93% of the value of the shipment. These costs were divided as follows:

Table 9.1: Estimated actual and excess costs of transport and Customs clearance in India at Petrapole

	<i>Cost as % of average shipment value</i>		
	Ideal or normal	Excess	Actual
Transport and Customs clearance time	1.71	5.73	7.44
Speed money	-	2.50	2.50
Time for receipt of export remittance	0.22	2.15	2.15
Total	1.93	10.38	12.31

These costs are based on averages of the relevant variables, and the variances are considerable with some very high maximum values e.g. excess transport and Customs clearance costs as high as 18%

⁹⁶ The survey obtained apparently reliable information on “speed money” at Petrapole, apparently because people had no or few reservations about discussing it since it is so prevalent and open. However no information was asked for or provided on underinvoicing, misclassification and similar practices, most of which probably takes place on the Bangladesh side in connection with Customs clearance and which involve much larger bribes and other side-payments than the amounts involved in speed money payments.

of the average shipment value. However, as the paper points out, the shipment values to which they are related are averages of all the commodities that the respondents were shipping, and the estimates thus do not pick up differences between different types of commodity, which are likely to be considerable. They also depend on respondent estimates of opportunity costs, the basis for which is not known.

In order to obtain a better idea how these costs vary across different types of commodity, for this synthesis the data on time delays, speed money, and export remittance delays was combined with data from the same NCAER survey on shipment values by commodity, and information on Indian trucking costs from another study⁹⁷. These calculations (Table 9.2) show that the impact of the Petrapole bottlenecks is serious for low value commodities but minimal for high value commodities⁹⁸. For example, the total logistics cost for a truck load of wheat valued at Rs 56,000 was 10.94% of the value of the wheat, but without the excess transport and Customs clearance time and delay in receiving export remittances, and without “speed money” payments, the total cost should have been 1.96% of the value of the wheat. Thus congestion and logistics inefficiencies added to the cost of getting the wheat from Kolkata through Petrapole to the Bangladesh Customs clearance point at Benapole, and increased its landed cost there by about 9%. By contrast, the total logistics cost for a truck load of truck and motor parts valued at Rs 2.7 million was only 0.75% of the cargo’s value, and would have only been 0.12% of the value under ideal conditions. The reasons for these large differences between low value and high value commodities is that wasted truck time and speed money are the same regardless of the value of the cargoes that the trucks are carrying, and therefore are more significant for low value cargoes. On the other hand, in these calculations the cost of the time delays for the cargoes has been estimated as the interest cost of working capital, which has been assumed at 1% per month. These costs i.e. the interest cost of the shipments while they are being transported and cleared by Indian Customs, and the interest cost of delays in payments for the export cargoes, are the same percentages of their values whether they are high or low. However this leaves out other costs of delay which for some products may greatly exceed the simple working capital interest cost e.g. deterioration of perishables such as fruits and some other foods, and buyer penalties for not meeting agreed delivery times. In addition, as already noted, the study is also confined to delays and other costs borne by Indian exporters: delays and other costs in clearing Customs in Bangladesh side of the border obviously increase the total logistics cost of the trade above the costs incurred in India.

The NCAER survey at Petrapole did not systematically investigate the logistics costs of Bangladesh exports to India, but according to the authors⁹⁹ Bangladesh exporters are treated in an unsympathetic and discriminatory way at Petrapole. For example:

- At the border Bangladesh trucks have to give way to Indian trucks going in the opposite direction with waits of 4-5 hours to cross.
- Once the trucks enter India, immediate transshipment to Indian trucks is required, since there is no bonded warehouse in which the goods can be stored. As no facilities are provided for the transshipment, damage to the goods results

⁹⁷ Subranamian, Uma et al op.cit Appendix 6

⁹⁸ It is likely that these commodity-specific estimates somewhat overstate the differences: in particular the very high estimates for cement and bauxite look implausible. For products such as these it is possible that extra speed money might be paid to shorten the time the trucks spend clearing Customs, reducing the total per truck cost. Another possibility is that lower speed money rates and faster clearance times are established for obviously low value cargoes such as cement, perhaps reflecting the view that excessive payments and delays would reduce the traffic in these products. These possibilities could not be explored in the survey, which was only able to obtain information on speed money and delays for an average mix of all the products being transported, not according to the type of merchandise the trucks were carrying.

⁹⁹ Ibid pp 11-12

○ Bangladeshi exporters complain that they are badly treated when entering India at Petrapole, despite paying substantial bribes. Consequently they prefer to fly to Kolkata in order to explore business opportunities, even though the cost is much higher than the cost of land travel. Issues such as these are of considerable interest and concern in Bangladesh and would be worth exploring in follow-up studies. These would need to be done in Bangladesh and in a carefully focussed way in India, in view of the very low volume of the trade and the small number of commodities involved.

The paper makes a strong case for investing in larger and much improved infrastructure and facilities at Petrapole and at the other land border Customs stations. The desirability of doing so is apparent from the extra logistics costs illustrated in Table 9.2 e.g. for Bangladesh the present system involves substantial terms of trade losses, since the landed costs of imports from India of products such as wheat, rice, fruit, cattle feed, bauxite and other products appear to be much higher than they would be if the congestion were removed. Bangladesh exporters and potential exporters also have an obvious interest in faster and less expensive commodity movements across the border. Likewise, on the Indian side, even though it can be assumed that the congestion costs of exports to Bangladesh are recovered in the prices charged, at higher prices the volumes of the exports must be lower than they otherwise would be. If the required investments are not made, congestion will increase with the general growth of trade, and would largely cancel or offset economic benefits that would otherwise occur if tariffs or other trade barriers were to be reduced. This last point is especially relevant if India and Bangladesh were to ever implement an effective FTA, since without very substantial investments in infrastructure and administrative capabilities, increases in trade would be slowed down or blocked by increases in congestion and the associated increases in economic rents.

Table 9.2: Estimated total extra cost for Indian exporters of delays and "speed money" at Petrapole land border crossing. Cost per 10 ton truckload by various products

	Value of shipment per truck Rs '000	Interest cost Rs	Truck cost Rs	Speed money Rs	Total cost Rs	Total cost as % of shipment value
Cars	3077	4277	3553	1202	9032	0.29
Engineering equipment	2800	3892	3553	1202	8647	0.31
Truck and motor parts	2727	3791	3553	1202	8546	0.31
Electric pumps	2500	3475	3553	1202	8230	0.33
Fans	1502	2088	3553	1202	6843	0.46
Cosmetics	1449	2013	3553	1202	6768	0.47
TV/VCD parts	1424	1979	3553	1202	6734	0.47
Stabilizers	1369	1903	3553	1202	6658	0.49
Cotton yarn	904	1257	3553	1202	6012	0.66
Paper	884	1229	3553	1202	5984	0.68
Air conditioners	625	869	3553	1202	5624	0.90
Bleaching powder	600	834	3553	1202	5589	0.93
Cumin seed	524	728	3553	1202	5483	1.05
Red dry chilly	460	639	3553	1202	5394	1.17
Paints	450	626	3553	1202	5381	1.20
Milk powder	414	576	3553	1202	5331	1.29
Bicycle parts	375	521	3553	1202	5276	1.41
PVC pipes	355	493	3553	1202	5248	1.48
Mustard oil	350	487	3553	1202	5242	1.50
Marble slabs	290	403	3553	1202	5158	1.78
CI sheets	240	334	3553	1202	5089	2.12
Lentils	220	306	3553	1202	5061	2.30
MS rods	200	278	3553	1202	5033	2.52
Black stones	197	274	3553	1202	5029	2.55
Jute carpets	180	250	3553	1202	5005	2.78
Apples	120	167	3553	1202	4922	4.10
Pig iron	113	156	3553	1202	4911	4.37
Sugar	107	149	3553	1202	4904	4.57
Glass ware	90	125	3553	1202	4880	5.42
Mangoes	80	111	3553	1202	4866	6.08
Rice	79	110	3553	1202	4865	6.13
Wheat	56	78	3553	1202	4833	8.66
Cattle feed	49	68	3553	1202	4823	9.93
Cement	22	30	3553	1202	4785	22.26
Bauxite	21	30	3553	1202	4785	22.44

Notes: Estimates based on data collected in NCAER survey of exporters and transporters in Kolkata-Petrapole region during July and August 2002. Supplemented by estimates of Indian trucking costs in India in Annex 6 of Uma Subramanian et al. This estimates the annual total cost of a 10 ton truck at \$US 12,385. The fixed component of this after deducting tyre and fuel cost is \$6440 per annum, or \$17.60 per day. The average delay per shipment which the exporters and truckers interviewed by NCAER thought was unnecessary or excessive was about 100 hours or 4.17 days per truck. This was used to estimate the cost of the delay per truck and the working capital interest cost, assuming an interest rate of 1% per month. It was assumed that "speed money" is the same for each truck regardless of its cargo. Bribes related to Customs clearance are not included in these costs, and no costs incurred in Bangladesh after the goods have been unloaded there for Customs clearance, are included in these estimates

Chapter 10: Quantifying the economic costs and benefits of an FTA: some industry case studies

If there were a bilateral free trade agreement between India and Bangladesh, or if SAFTA is eventually implemented in a comprehensive way, there would be economic costs and benefits for various groups in the two countries and for the two governments, and also repercussions affecting exporters and importers outside the South Asia region. The likely size of these effects and how they would be distributed is relevant for people involved in the discussions on preferential trade policies in the two countries, and also for trade policies more generally. In order to bring out these issues in a reasonably non-technical way, a methodology was developed for analysis at the level of individual industries, and applied in a number of industry case studies. It is hoped that these can serve as models for similar studies of the likely impact of an FTA or of SAFTA on other industries. The main features of the methodology are briefly summarised below. This is followed by an outline of the principal results of the empirical case studies, including some unexpected by-products that the case studies turned up. The concluding section then outlines the implications of the case studies for India's and Bangladesh's policies on preferential and free trade, and for their trade policies more generally.

*Methodology.*¹⁰⁰ Even though SAPTA and various bilateral preferential trade agreements have been operating in South Asia for a number of years, and it has been agreed to begin implementing SAFTA from January 2006, there is little no recognition of their potential economic costs and benefits, either in the texts of the agreements or in the general statements and discussions that have accompanied them. The negotiations and the debates have been almost entirely mercantilist, focusing on the extent to which under the agreements national industries do or do not obtain new export opportunities, resisting concessions that might provide serious competition for established local industries, and worrying about losses of Customs duty revenue. Little or no attention has been paid to the potential for trade diversion costs, by which trade may be diverted from low cost suppliers in other parts of the world to higher cost suppliers in South Asia, or to the potential consumer costs and benefits. One purpose of the methodology paper and of the applications of the methodology to some industry case studies of free trade between India and Bangladesh, is to make these basic issues clear, realistic and it is hoped easily understood by non-specialists in these two countries and in South Asia more generally. With this in mind a traditional and highly simplified comparative static framework has been used and applied to bring out the main points, fully recognizing that the simulated results for individual industries would need to be modified if general equilibrium including macro-economic repercussions (e.g. exchange rate effects) were considered. To simplify the presentation and also the empirical estimation of welfare changes, the models use linear demand and supply functions, and except where otherwise indicated, assume competitive behavior on both the supply and demand sides. Market structures in South Asia-especially in manufacturing-are often far from competitive, but as a first approximation it is useful to look at the outcomes on the assumption that firms behave *as though* they are competitive. This provides a benchmark which can be modified to allow for various forms of non-competitive behavior in simulating the likely outcome of an FTA.

Changes in "economic welfare" resulting from an FTA are treated as the sum of changes in consumers' surplus, producers' surplus and government revenue from tariffs (customs duties). Consumers' and producers' surpluses are a shorthand way of summarizing economic benefits that may accrue to a variety of economic agents, not just final consumers and producers¹⁰¹. For example,

¹⁰⁰ The methodology is described in Pursell, Garry (2004, Dec 14): *Analyzing the Economic Welfare Consequences of a Free Trade Agreement; Partial Equilibrium Methods for Industry Level Studies*.

¹⁰¹ On the welfare estimates, in principle, compensating variations should be estimated, not just areas under curves. However, that requires more reliable and complete information on both demand and supply parameters, and also better information on prices and industrial structures. The case studies are intended to illustrate some

governments normally share in producer surpluses through taxes on profits, and some shares may go to foreigners if there is portfolio and/or foreign direct investment (FDI). It is also likely that traders (e.g. wholesale distributors and exporters) may share in producer surpluses, especially exporters who undertake marketing functions. Consumers' surpluses may refer to benefits to buyers of intermediate goods and equipment, not only benefits to final consumers, and in practice they include increases or decreases in the number of specifications, qualities or brands of a given good that are available to consumers as a result of trade policy changes e.g. consumers may benefit just because of an increase in the number of brands and varieties that are available, even if there is no change in the prices of the existing varieties.

Only protective tariffs have been considered in estimating the fiscal costs of FTAs, not indirect domestic taxes such as the VAT in Bangladesh and the additional (excise) duties and sales taxes in India. The latter are general taxes which are applied to both imports as well as domestic sales, and imports under preferential agreements such as FTAs are not exempt. Therefore, if as a result of an FTA duty free imports into Bangladesh of product *x* from India replace imports of *x* from the rest of the world (ROW), the loss of Customs revenue is just the protective tariff (customs duty plus para-tariffs) that would have been paid on the imports from ROW, not the Bangladesh VAT on those imports, since that is also charged on the imports from India. However smuggled goods will usually avoid domestic indirect taxes as well as tariffs, so if there is smuggling this needs to be taken into account in simulating the fiscal effects of an FTA.

The comparisons of pre and post-FTA situations are of standard comparative static "long run" equilibria which assume that all the short run adjustments have been made on both the supply and demand side. As with any comparative static analysis, in principle it is possible to estimate the likely path to a new equilibrium and to calculate the present value of the change, but the information required to do that with confidence is generally difficult to obtain. The main concern for policy-makers in this adjustment process is usually the employment consequences for industries that as a result of an FTA would face tougher competition and would be obliged to contract and/or improve their efficiency. If some quantitative estimates can be obtained on the scope for productivity improvements, this can be modelled and some rough estimates of the differences this might make to economic welfare outcomes are provided in the cement industry case study. However, it is much more difficult to estimate the likely contraction path of firms and industries which in the short run are likely to stay in business provided they can cover their variable costs, but which would eventually cease production. During this process the resulting annual producer surplus losses are likely to be higher than in the eventual long run equilibrium in which the macro-economy is assumed to have adjusted so that the equivalent of the labour, capital and other resources released by the contracting firms have found employment elsewhere. On the other hand, consumer benefits may be greater during the process than estimated for the long run equilibrium, if the prices of the exports from the partner FTA country (say Indian firms exporting to Bangladesh) charge lower prices in order to meet the competition of Bangladesh firms which base their prices on their variable rather than their total production costs. The continuing production of the Bangladesh firms would in general also mean that the government will continue to collect import duties on imported inputs, reducing the estimated government revenue loss during the adjustment process below the eventual revenue loss in the long run equilibrium when the Bangladesh firms will have ceased or cut production.

For convenience the case study comparisons of economic welfare use a common numeraire which could either be the currency of one of the countries or a common foreign exchange numeraire (e.g. the US dollar). This means that changes in consumer surpluses, producer surpluses, and customs revenue are valued equally, both within each country and across countries. These could obviously be valued

general points about the likely levels and distribution of welfare changes. These could be refined in subsequent studies.

differently e.g. in Bangladesh a Taka or dollar of customs revenue could be valued more or less than a Taka or dollar of consumer benefits resulting from a reduced price of some commodity, and a dollar of producer surpluses in India could be weighted differently from a dollar of producer surpluses in Bangladesh. This is always possible in any kind of economic welfare analysis, but before this is done, it is useful to calculate a starting point with known weights to provide the direction and provisional size of the welfare changes.

The methodology recognizes that a free trade agreement is very different from a common market. In particular, whereas a common market will tend to equalize prices in the member countries, with an FTA domestic prices for a given commodity in participating countries can differ, perhaps substantially-in fact that is likely to be the norm rather than the exception. Apart from differing domestic indirect taxes, for internationally traded goods, this is principally because the member countries maintain their own tariff structures, and because duty free access to the markets of the other FTA member or members is always subject to rules of origin requiring minimum levels of national content which have to be verified with documentation presented as part of Customs clearance. Unless there is smuggling, these formal Customs requirements for trade prevent the kind of arbitrage that tends to equalize prices at all stages-ex factory, wholesale and retail-within a common market. Moreover, goods exported to an FTA partner country can normally be sold equally profitably at lower prices than the prices of the same goods sold domestically, because (as is the case with all exports) the tariffs on the imported inputs used in their production are rebated or exempt. For these and other reasons, how domestic prices are determined following an FTA, and the resulting repercussions on the economic welfare of the various groups that are affected, can be quite complex.

The methodology also recognises the importance of the informal and illegal trade, specifically the “bootleg” and the “technical” smuggling from India to Bangladesh. As pointed out previously, the “bootleg” smuggling across the border amounts to a *de facto* trade arrangement under which the Indian products being smuggled do not pay Bangladesh’s customs duties and VAT, but are subject to various informal private payments to officials in both countries. Just as under a formal FTA or preferential agreement, the smuggled imports potentially divert imports that would have otherwise come from the rest of the world (ROW) and India by the formal channels, provide competition to Bangladesh producers, and potentially benefit Bangladesh buyers to the extent that the smuggling reduces prevailing prices and provides qualities and varieties that would otherwise not be available. The fact of this already pre-existing *de facto* informal preferential trade needs to be taken into account in assessing the likely consequences of a formal FTA, and various possible outcomes are discussed in the methodology paper.

One key consequence that the paper brings out is that the cost of smuggled goods by the “bootleg” route, on the Indian side includes Indian domestic taxes, wholesale and perhaps retail margins, Indian smuggling margins, plus bribes paid to Indian officials. These costs and economic rents can be expected to be included in the price charged for the smuggled goods when they arrive in Bangladesh, and so the trade involves possibly substantial economic benefits to the smuggling networks in India as well as in Bangladesh. However, if a formal FTA including the smuggled products is agreed, it is likely that the formal trade will substitute or perhaps completely replace the bootleg smuggling trade. This is because, like all exports, the exports under the FTA would be exempt from Indian domestic indirect taxes, would benefit from standard export duty neutralisation facilities such as duty drawback and DEPB, and - providing transport and Customs facilities are adequate-in principle can be shipped in larger quantities involving lower transport logistics costs and trader margins. Therefore one of the consequences of a formal FTA will be to reduce or perhaps eliminate the transaction costs and economic rents of the bootleg smuggling trade, both in the exporting country and in the importing country. In principle, these economic costs and benefits would need to be considered in assessing the likely overall economic consequences of the FTA.

The methodology paper also discusses the likely effects of an FTA in the case of products which are being smuggled by the “technical” smuggling route. The products going by this route are not subject to Indian domestic indirect taxes, but there are reports that at the Petrapole land border many forego the usual Indian duty neutralization rebates in order to avoid or minimise checks by Indian Customs officials. The principal consequence of an FTA for these products is that it would remove most if not all of the bribe extracting leverage of Bangladesh officials, so that in assessing the economic consequences of the FTA in Bangladesh, there would be two separate economic losses at the border, the loss of Customs revenue that was previously collected, and secondly the loss of the Customs and other officials’ economic rents, which effectively are a form of privatised Customs revenue. A variant of this outcome, also discussed in the paper, is the possibility that the combined rate of Customs duties actually collected plus the bribe rate is less than the total formal import duty rate. In that case the leakage at Customs may be affecting the price level of the product in Bangladesh, so that the de facto protection to domestic producers may be lower than the apparent protection rate in theory made available by the official Customs duty and para-tariff rates. The in turn will reduce the potential consumer welfare benefits of the FTA in Bangladesh, since they are already benefiting to some extent from the smuggling. On the Indian side, another outcome of an FTA is that the Indian exporters would no longer have a motive to not collect the available export rebates such as DEPB and drawback, and this extra cost to the Indian government would need to be taken into account in assessing the net benefits (mainly increased Indian exporter producer surpluses). Depending on the competitiveness of the Indian exporters, there could also be welfare benefits in Bangladesh if the Indian exporters pass on the duty neutralization payments they receive to their Bangladesh customers.

By definition, free trade agreements (and more generally any kind of preferential agreement) discriminate against imports from rest of the world (ROW) countries that are not parties to the agreements. Insofar as the imports from the ROW countries that are excluded are traded at lower prices than the imports from the FTA countries, there is an economic welfare loss for the FTA members, and also an economic loss for the ROW exporters who lose their markets. These trade diversion effects need to be allowed for in any comprehensive evaluation of the costs and benefits of FTAs, but in practice those negotiating or managing most FTAs only pay attention to the Customs revenue losses from the diverted trade, and zero attention to the economic losses of the affected ROW exporters. This point is recognised in the methodology, but it notes that the information that would be needed to provide some quantification of the economic losses in ROW countries is normally not available, especially if a large number of ROW exporters are affected. However, the difficulty of quantifying these effects does not diminish their importance, and as a rule of thumb it might be plausible to assume that the per unit producer surplus losses resulting from the excluded ROW exports at least equal the producer surplus gains of the new exports from the FTA member that replaces them. This kind of calculation is discussed in the cement industry case study, where it appears that an India-Bangladesh FTA would exclude Indonesian, Malaysian and Thai clinker exporters from the Bangladesh market.

*Summary of industry case studies*¹⁰² This section summarises some of the principal findings of case studies which simulated the likely effects of an India-Bangladesh FTA in the following industries¹⁰³:

- Cement
- Light bulbs
- Bicycle rickshaw tyres
- Sugar

¹⁰² At the time this synthesis was prepared final drafts of the case studies of fluorescent lights, bicycle rickshaw tyres and passenger cars were not available owing to missing and inconsistent data and various other loose ends that still needed attention. This summary is based on early working drafts

¹⁰³ Case studies also included fluorescent tube lights and passenger cars, but results were too preliminary to be cited here.

Ready made garments

In interpreting these case studies, an important caveat is that only very limited empirical survey work was done in preparing them, and so if only for this reason the estimates of economic welfare costs and benefits *are preliminary estimates only* which would be certain to change with more complete knowledge of the various parameters on both the demand and the supply side of these industries in both countries. Most of the simulations take as a base scenario the situation (i.e. demand, production, market structure, imports, tariffs, exports etc) during Bangladesh's 2002/03 fiscal year, as that was the latest year for which reasonably complete data was available when the studies were started. Among other things, the situation in these industries will have changed since 2002/03, and of course this would need to be allowed for in current thinking about the likely impact of an FTA.

In the simulations for the first four of these industries, it turned out that under an FTA there are expanded Indian exports to Bangladesh, but no exports from Bangladesh to India. This was not predicted in advance, but was a result of finding that in the 2002/03 base scenario (a) India was exporting all these products to the rest of the world and –except for cement–also to Bangladesh (b) Indian export prices were substantially lower than ex-factory before-tax prices of the same or similar products in Bangladesh (c) none of the products were being exported from Bangladesh (d) potential export supply prices in Bangladesh–defined as ex-factory prices minus estimated duty drawback for inputs subject to tariffs–in each case substantially exceeded ex-factory prices in India.

The results point to Bangladesh's apparent lack of comparative advantage viz a viz India, which is not surprising in that the broad comparative advantage of both countries is in relation to developed countries, but this is especially the case with Bangladesh which has a much less diverse industrial and agricultural structure than India. However, comparative advantage is not static and is changing all the time, so in the medium to long run there will be industries established in Bangladesh which will find it profitable to export to India, based on factors such as lower labour costs, resources such as natural gas, or transport costs and proximity (the latter especially in relation to the Indian NE states). The problem is that it is difficult to predict what these future exports might be: all we could do in the various studies was to look at the evidence from Bangladesh's actual present trade and industrial structure, and on that basis there doesn't seem to be many possibilities for substantial exports right away¹⁰⁴.

The simulations for ready made garments (using the example of mens' cotton shirts and trousers) predict increased Bangladesh exports to India, but also increased RMG exports from India to Bangladesh.

In the base simulations for cement, light bulbs, fluorescent tube lights, bicycle rickshaw tyres, and sugar, following an FTA production in Bangladesh ceases altogether and the entire Bangladesh market is supplied by imports from India. In each of these industries, this seemed to be the most plausible likely outcome *given* the information obtained on prevailing prices and costs in Bangladesh, even after allowing for cost reductions that would result from duty free imports of intermediate inputs from India that would also result from an FTA. It was not a surprising outcome in view of the very high protection rates all of these industries were receiving in Bangladesh, and the fact that –despite apparently substantial smuggling of a number of these products–actual domestic prices were approximately reflecting the tariff protection that had been provided. The protective tariff rates (Customs duties plus para-tariffs) in 2002/03 were:

¹⁰⁴ It is possible that the potential for Bangladesh exports to India is larger than can be inferred from the existing situation. But from the available evidence it is hard to argue convincingly for a large expansion of exports from Bangladesh to India for the time being. The rest is speculation, though plausible.

Cement	66.7%
Light bulbs	66.0%
Fluorescent tube lights	75.3%
Bicycle rickshaw tyres	35.5%
Sugar	86.4%
Automobiles	59% or 89% (2004/05 tariffs)
Ready made garments (cotton shirts & trousers)	65.5%

In the simulations for the first six of these industries, the duty free imports from India create economic welfare benefits for Bangladesh consumers which considerably exceed the economic welfare losses of Bangladesh producers plus the government fiscal losses which are a result of the zero tariffs on the imports from India. Hence, in each case, the FTA creates a substantial net welfare benefit for Bangladesh. Because of the very high Bangladesh tariffs and the resulting large gaps between the protected prices pre-FTA and India's export prices, these welfare rectangles and triangles are much larger than the welfare amounts often found in similar exercises in other countries. In particular the net quantifiable economic annual welfare benefit for Bangladesh from an FTA with India that includes sugar is estimated at \$153 million, and for cement at \$171 million.

Since Indian exports expand there are also economic benefits for the Indian producers (producer surpluses), so in each of these cases the net joint economic benefit to Bangladesh and India together exceeds the net economic benefits in Bangladesh alone. On the other hand the FTA diverts trade from the countries that were previously supplying Bangladesh with imports of the finished products or with inputs for the Bangladesh industries that cease production following the FTA. The case studies do not provide information that would allow the welfare losses in the ROW countries to be estimated, but in no case is the value of the excluded exports sufficient to generate plausible producer surplus losses that would be large enough to offset the joint benefits of the FTA in Bangladesh and India.

The simulations do not allow for the likelihood that efficiency improvements and cost reductions would take place in the Bangladesh industries under the spur of import competition, and therefore the local Bangladesh industries cease production. In only one case-cement-did the Bangladesh firms surveyed provide any indication of the likely scope for cost reductions-and in that case the estimated reduction was still not sufficient to prevent the demise of the industry under the simulated FTA. A useful supplement to these and similar studies would be to look more carefully at the potential for cost and price reductions in protected domestic industries in Bangladesh and the extent to which the industries would survive and prosper without protection. If they would, the economic welfare benefits of an FTA in Bangladesh would be larger than estimated in these case studies, because of lower producer welfare losses to be subtracted from consumer welfare benefits.

With the exception of the RMG case study, the economic welfare outcomes depend crucially on what is assumed about competition between Indian exporters to Bangladesh following an FTA. The base scenarios assume that the Indian industries are competitive and following an FTA would export to Bangladesh at the export prices they were charging prior to the FTA in selling to the rest of the world and to Bangladesh. But in signing on to an FTA with India, Bangladesh in effect would be extending its general tariff protection levels to Indian as well as to Bangladesh producers, and this raises the possibility for the Indian firms to collude and sell to Bangladesh at higher prices than their prevailing export prices to the rest of the world, and even at higher prices than their prevailing domestic prices. If that happens, as discussed in some of the case studies, the Indian industry extracts a share of the consumer welfare benefit that would have gone to Bangladesh consumers in a competitive scenario.

The simulations in which this possibility is modelled, drastically alter both the overall level of the economic welfare changes, and how they are distributed within and between the two countries. For

example, in the case of the cement industry, with a collusive profit maximising price for the Indian exporters there is still an overall substantial (although reduced) positive joint net benefit for Bangladesh and India together, but the net welfare change in Bangladesh is negative (minus \$22 million) while there is a large positive welfare benefit (+\$178 million) in India. Bangladesh cement consumers still benefit from lower prices than before the FTA, but these benefits are now less than they were in the first simulation, and are more than offset by the producer surplus losses of Bangladesh cement producers who still go out of business, plus the government's loss of tariff revenue. In advance, the likelihood of this happening is difficult to predict, but its possibility underlines a key difference between an FTA and unilateral general trade liberalisation, where the Indian exporters to Bangladesh are competing with ROW exporters, and as a result are unlikely to have much if any market power in Bangladesh.

The sample of industries studied does not include any cases in which, before the FTA, the Indian industry is not exporting but has lower costs than the Bangladesh industry. In that case it would be likely to export to Bangladesh following an FTA, but at higher prices than prevailing world prices, even though the industry is competitive and there is no collusion or price fixing in the Bangladesh market. This possibility is discussed in the methodology paper, which points out that in such a case the resulting terms of trade loss for Bangladesh is principally explained by the excess production costs (relative to world prices) of the Indian suppliers, whereas in the collusion case it is absorbed by economic rents (higher profits) which do not involve real resource costs. This increases the probability that the net welfare outcome for India and Bangladesh jointly will be negative, depending on the extent to which the preferential export prices exceed world prices. Following the reduction of India's general maximum industrial tariff to 15% in March 2005, the scope for welfare reducing exports of this kind under an FTA is less than it used to be, and the same tariff reduction also leaves reduced scope for similar welfare-reducing exports from Bangladesh to India, since the 15% tariff in principle constitutes an upper limit on the excess of the price at which the exports could sell in India, over cif import prices from the rest of the world.

Because of the prevalence bootleg and "technical" smuggling from India to Bangladesh, some economic welfare accounting is needed to allow for the effects of an FTA on the economic rents earned in these activities. There is an extensive discussion of this topic in the sugar case study and it is also dealt with in some of the others e.g. in the rickshaw tyre case study. The sugar case study recognizes that economic rents from smuggling also exist in the exporting country, and points out that an FTA will reduce these rents, partially or even fully offsetting the economic benefits of the FTA to Indian exporters.

The RMG industry case study was chosen to explore the possibility of Bangladesh exports to India following an FTA and the economic welfare consequences. As expected, lower wages in Bangladesh than in India combined with similar labour productivity mean that RMG production costs in Bangladesh are lower than they are in India. Moreover, some Bangladesh exports to India of mens' and boys' woven shirts started in the late 1990s and were growing fairly rapidly up to 2003/04, although starting from a very low level. Since these exports were taking place over fairly high Indian tariffs (28.4% for shirts in 2003/04) it seemed plausible that exports would increase at a faster rate under an FTA, and the economic welfare consequences were estimated for alternative annual export levels to India of \$8.5 million and \$41 million. The paper argues that higher export levels for Bangladesh shirts than these are unlikely because of evidence that the Indian domestic market for RMGs is highly competitive, with domestic prices not far above fob export prices. It also argues that some part of increased Bangladesh exports to India would be diverted from exports to other countries, so that the net export increase from the opening to the Indian market provided by the FTA would be less than the increased exports going to India. It then calculates some illustrative economic welfare benefits that the exports would generate in Bangladesh, estimating them at between \$1.1 million and about \$5.6 million annually. Most of this is attributable to producer surplus benefits of Bangladesh RMG exporters, offset to a minor extent by consumer surplus losses due to consequent small increases in domestic RMG prices in Bangladesh. There

is a welfare benefit for Indian consumers resulting from the Bangladesh exports to India, but a somewhat larger loss for Indian RMG producers, who (as in all FTA arrangements) are obliged to compete on unequal terms in their domestic market with the Bangladesh producers, since the Bangladesh producers obtain their inputs duty free, whereas the prices of the inputs of the Indian producers selling domestically are raised by tariffs.

As noted in the general methodology and as applied in the case studies, costs and benefits to the consumers, producers and the governments in both India and Bangladesh are weighted equally by expressing and comparing them in money terms. In most of the case studies there is a net welfare gain from the FTA because the benefits to consumers are greater than the losses of producers plus the revenue losses of the governments. These net outcomes would change if the effects on the various groups were to be weighted differently. In this regard, however, it is relevant to note that if low income and poverty considerations were to be taken into account in deciding on the weights, the preponderance of consumer benefits might be even greater than is the case with equal weights. For example, in the rickshaw tyre case study, benefits of lower tyre prices to the rickshaw wallahs and their customers would probably have high weights and the economic welfare calculation in this case would favour the FTA even more. Similarly, the high prices of sugar and cement created by the high protection policies being followed in Bangladesh towards these industries are very regressive, and unequal welfare weights designed to take account of poverty and low incomes would also increase the estimated net welfare improvement in Bangladesh from an FTA.

Chapter 11: Implications for Bangladesh and Indian trade policies

Implications for Bangladesh. The simulated economic effects of an India-Bangladesh FTA in the industry case studies which predict Indian exports to Bangladesh, all indicate large economic welfare gains for Bangladesh consumers which far outweigh the total of government revenue losses, producer surplus losses resulting from the contraction of Bangladesh production, and losses of economic rents in Bangladesh resulting from the contraction of both “bootleg” and “technical” smuggling. In addition, an FTA would also generate some Bangladesh producer surplus gains from expanded exports to India, but these are likely to be quite limited owing to the highly competitive nature of most Indian markets. All this presupposes that infrastructure and administrative capacity would be greatly improved and expanded on both sides of the land border crossings to reduce bottlenecks and to stay ahead of the expanded bilateral trade, otherwise the economic welfare gains from the FTA would be severely compromised by increasing congestion, delays and informal payments.

The prediction that an FTA with India could bring large net economic welfare benefits for Bangladesh must be qualified by some important risks:

- By providing a captive protected market to Indian suppliers, there is a risk that instead of exporting to Bangladesh at prevailing world prices, the Indian producers will collude with each other and possibly with some Bangladesh producers and set prices that will transfer most of the economic benefit of the FTA arrangement to India. As noted in the simulations for the cement and sugar case studies, if these prices are sufficiently high there could be a net economic welfare loss for Bangladesh, with consumer surplus benefits insufficient to outweigh government and producer surplus losses.
- There is a risk of terms of trade losses for Bangladesh if, following the FTA, some Indian industries export to Bangladesh at competitive prices which are nevertheless higher than prevailing world prices. As it happened, none of the few industries chosen for study in the project fitted this pattern, but it is highly likely that would be some among the large numbers of products being produced in India but not currently being exported. The terms of trade loss for Bangladesh in such cases is the excess of these Indian export prices over cif import prices when the same products are imported from the rest of the world.
- In the recent past India has subsidized its exports of rice, wheat and sugar in order to get rid of excess stocks generated by problems with its domestic support and other policies. Bangladesh has benefited from these subsidies by importing Indian supplies of these commodities at the subsidized prices. However, if Bangladesh were a captive market for these products under an FTA, India would be able to supply Bangladesh at whatever higher prices would be possible given the Bangladesh MFN tariffs, probably involving lower or zero Indian export subsidies. Under an FTA, Bangladesh might also forego similar benefits in importing other commodities subject to similar cyclical production and world price patterns

These risks for Bangladesh of an India-Bangladesh FTA are substantial and serious, and raise the basic question: why not aim to obtain the same economic welfare gains by from a policy of multilateral import liberalization, which could produce the same consumer surplus benefits for Bangladesh consumers and the same net domestic economic benefits, while avoiding the risks? With multilateral import liberalization, there would be no producer surplus benefits for Bangladesh exporters from protected preferential markets in India, but the potential for these appear to be quite limited, owing to India’s recent reductions of its industrial tariffs to quite low levels, and tariff redundancy in its protected agricultural and textile and clothing sectors. Multilateral import liberalization would also not disadvantage third countries, which in the case of Bangladesh are largely other developing countries. To implement such a policy, first priority would be to phase out the para-tariffs, eliminating first of all the use of the VAT and the supplementary duties as protection instruments, and moving towards a simple, low and uniform

Customs-duty plus VAT import duty structure, along the lines of the structure currently in place for nearly all of India's industrial products.

Implications for India India's trade with Bangladesh is very small relative to its total trade and to its economy, and so the economic welfare consequences of an FTA involving Bangladesh (whether bilateral or as part of SAFTA) are also quite minor even though they are significant for Bangladesh. As discussed above, there are potential producer surplus benefits for Indian producers and traders from the expansion of exports to Bangladesh that would result from an FTA, and these might be increased further if some Indian industries were able to effectively collude in supplying Bangladesh under the umbrella of high Bangladesh MFN tariffs. However, in such situations it would probably be unlikely that Bangladesh would maintain high MFN tariffs if the principal impact of such tariffs would be to facilitate the transfer of economic rents to Indian suppliers. Furthermore, there would be offsetting losses of economic rents-including Indian indirect taxes-associated with the smuggling networks on the Indian side of the border, given the likelihood that the FTA would divert trade to the legal routes.

The RMG case study suggests the possibility of some Indian consumer welfare benefits from Bangladesh RMG exports to India under an FTA, but these and other potential consumer welfare benefits appear to be quite limited in view of the current general openness of India's industrial import policies, and the competitiveness of domestic production and prices in most of the sectors with high and very high import protection, notably agricultural products and the textile and clothing sectors protected by specific tariffs. In addition, any likely expansion of Indian exports to Bangladesh under an FTA is likely to be very small relative to the total Indian market, with no or minimal impact on prices, except possibly in some border areas for some products. Consequently, Indian policy does not need to be concerned that export expansion to Bangladesh might produce significant consumer price increases.

All of this suggests that there is no compelling case for India to pursue an FTA with Bangladesh, based on the potential economic welfare benefits to India. Whatever economic benefits might result from an FTA with Bangladesh, are potentially available on a much broader basis and larger scale from continuing the general unilateral import liberalization process that has been under way during the past three years. This would pay special attention to non-tariff barriers and prohibitive tariffs in the agricultural sector (including livestock and fisheries products and processed foods) and to the specific duties protecting the textile and clothing sectors. In view of substantial tariff redundancy in most segments of these sectors, such policies would probably not require much producer adjustment and would provide some limited benefits to Indian consumers as well as some limited export opportunities for neighbouring countries including Bangladesh.

It could be argued that an FTA and MFN liberalisation could complement each other and that regional agreements are politically easier to institute and manage, and therefore the two should go hand in hand. For this argument to be valid, regional cooperation must have reached a high level to prompt a virtuous cycle of protection reductions. There are problems on the Bangladesh side due to (a) the very high protection levels to its import substitution industries (b) concerns about Customs revenue losses from an FTA (c) limited potential-in the short to medium run at least for Bangladesh exports to India under an FTA (d) the extreme political sensitivity in Bangladesh stemming from the fixation on the bilateral trade deficit with India, which is likely to increase rapidly and substantially under an FTA. For these reasons Bangladesh would only go into a bilateral FTA with India (or into SAFTA) if India were to agree to extensive concessions while Bangladesh would insist on a very extensive negative list.

Additionally, the fiscal consequences in Bangladesh can be managed much more effectively and directly with multilateral liberalization than under a bilateral FTA (or under SAFTA), since if an FTA is actually implemented there would be zero Customs duty revenue from imports from India, whereas MFN liberalization can be managed (as has been the case in India) with phased tariff reductions. A second

reason is that the studies show that there are already serious administrative problems and complexities in the Bangladesh tariff regime even though Bangladesh's SAPTA preferences are negligible. These complexities would be greatly magnified if Bangladesh started to phase in substantial tariff preferences and eventually exemptions as part of an FTA. A third reason is that tariff reform in Bangladesh needs to focus on the removal of the para-tariffs. While in principle that could go on simultaneously with FTA negotiations, the process would be much more complex, especially with regard to "sensitive" negative list industries. A fourth reason is that Bangladesh multilateral liberalization won't create a lopsided increase in the bilateral trade deficit with India: imports from India will increase, but along with imports from other countries. Finally, with general import liberalization there would still be an opportunity cost of not dealing with the trade infrastructure along the land border with India, but it wouldn't be concentrated there...it would also create pressure to deal with the infrastructure and administrative capacity at the seaports.

India-Bangladesh cooperation in other areas The suggestions above that both India and Bangladesh would obtain greater and more secure economic benefits by giving priority to unilateral trade liberalization on a multilateral basis, rather than by pursuing free trade arrangements, does not mean that other trade-related cooperative endeavors should be neglected. In particular there would be substantial benefits from coordinated improvements in the transport, storage and administrative infrastructures at and adjoining the India-Bangladesh land borders, as well as in harmonization and cooperation in Customs administration and banking relationships. As well as facilitating bilateral trade and reducing its cost, this would help reduce black economy activities in both countries associated with both the "bootleg" and "technical" smuggling routes, and improve fiscal resources, especially in Bangladesh. Finally, there is little doubt that regional cooperation in energy and infrastructure could yield dividends in terms of cross-border investments and joint ventures.

Chapter 12: Summary of key findings

General observations. India is now the largest single source for Bangladesh's imports (16% of total in FY05), ahead of China and Singapore. Bangladesh's perennial large bilateral trade deficit with India might be a cause for concern but it has not led to any balance of payments problem for Bangladesh as consistent trade surpluses with such trading partners as US and EU compensate for these deficits. The large volume of informal/illegal trade remains a problem though.

Taka/Rupee exchange rate and India-Bangladesh trade

- Bilateral Taka/Indian Rupee REER play an important role in affecting trade flows between India and Bangladesh. The appreciation of the real Taka/Rupee exchange rate by about 50% between mid-1980s up to about 1999, would have contributed to the expansion of both formal and informal Indian exports to Bangladesh, and retarded the growth of Bangladesh exports to India.
- Despite a reversal of exchange rate trend since 1999, Bangladesh exports to India stagnated. This could be due to (a) faster productivity growth in India bolstering India's comparative advantage in competing goods, and/or (b) tariff and non-tariff barriers constraining Bangladesh's major exports (RMG) or minor exports which have experienced rapid growth elsewhere.

India's trade policies

- **Import policies.** While liberalizing its import regime, India has used WTO-compatible rules for "contingent" protection – e.g. anti-dumping, standards. Though industrial tariffs in India are now mostly at 15%, specific tariffs on garments make it difficult for Bangladeshi garment exports to penetrate the Indian market.
- **Export policies.** India restricts the widely used DEPB scheme for exports over land routes –Petrapole being the only land border at which this duty neutralization scheme is allowed. Rebates under duty neutralization schemes have fallen considerably suggesting that domestic prices are close to fob prices and well below cif prices making it difficult for Bangladeshi exports to India to compete in the Indian market.

Bangladesh's trade policies

Import policies.

- Quite apart from the general constraints at land borders, both India and Bangladesh resort to limiting certain imports via designated land ports thus encouraging illegal imports – both cross-border and technical smuggling.
- Though custom duties have been brought down, para-tariffs imposed on top of custom duties, have led to a slowdown in reduction of protection since the mid-nineties.
- India exports a wide range of products to Bangladesh covering all but 4 of the 98 HS chapters, making up nearly 15% of Bangladesh's imports, excluding textiles, which mostly come in at zero tariffs. India is supplying a fairly constant share of Bangladesh's imports of basic raw materials, intermediate goods, capital goods and non-cereal consumer goods. This despite the fact that dutiable imports from India face import weighted tariffs of about 29%, suggesting that they compete favorably with imports from the rest of the world.
- Bangladesh granted few – mostly symbolic -- tariff concessions to India under SAPTA.

Export policies

- Bangladesh exports a miniscule (<1%) share of India's imports, a negligible share (1%) of its own exports, and a small range of products (fertilizer and jute goods made up two-thirds of exports).

- Bangladesh exports to India face tariffs of 15% for industrial products without SAPTA preference. That negligible amounts get exported suggest that they face major competition with imports from ROW. But, for goods with SAPTA preference and a rate of only 7.5%, there are not much exports either. Bangladesh business leaders tend to argue that SAPTA coverage is irrelevant as it excludes exports of interest to Bangladesh. For instance, specific tariffs on textile and garments keep off competitive imports from other developing countries, including Bangladesh.
- Bangladesh exports are dominated by RMG exports which import all raw materials under the bonded system free of custom duties. A 5% export subsidy exists on domestic fabrics/yarn used by garment exporters. Besides, there is an array of subsidies and bans on primary products (wet blue leather) which would have to be discussed with India in the context of an FTA or SAFTA.

Informal trade

- Informal and illegal trade between India and Bangladesh is substantial and, by some estimates, could be as high as three quarters of recorded trade. It is mostly one way -- from India to Bangladesh. Quite apart from the well-known cross-border informal trade, this study notes the existence of significant volumes of illegal imports into Bangladesh through legal channels (technical smuggling) by under-invoicing, misclassification, and bribery of customs.
- The study finds that preferences for formal trade will be influenced by the levels of Bangladesh protective tariffs, rigor of customs administration, and the state of infrastructure at border posts (roads, storage, technical and administrative capabilities).
- To reduce informal/illegal imports, both countries need to
 - ⇒ improve infrastructure – physical and administrative – at land border customs posts;
 - ⇒ streamline and harmonize customs procedures and administration at the border to reduce incentives for corruption
 - ⇒ expand facilities at smaller customs border posts
 - ⇒ For Bangladesh, bring down the high protective tariffs. Trade Liberalization Programme under SAFTA will facilitate this process.

Trade Financing and transaction costs

- A study of the financing of India-Bangladesh trade points out that the hawala networks perform better than the formal banking system in terms of simplicity, speed, transaction costs, and reliability, and that for these reasons they are not only financing much of the informal bootleg smuggling trade from India to Bangladesh, but also substantial parts of the exports to Bangladesh that go through the legal routes. If this is correct, they involve non-negligible transaction costs without protecting the suppliers and importers against commercial risks such as defective shipments, non-payment, delayed payments etc.

Reconciling the trade statistics

- The study made a detailed comparison of the Indian and Bangladesh statistics of bilateral trade. The purpose was to check any major discrepancies as to the general level of, and trends in, the total recorded trade. Such a comparison could throw light on the scale and scope of over-invoicing, under-invoicing, and similar practices, the likely products involved, and more broadly the potential scale of “technical smuggling”.
- There was greater convergence between Bangladesh export data and Indian import data. But discrepancies were found, at both the aggregate and product level, between Bangladesh import data and Indian export data. Bangladesh Bank import statistics appeared to be more complete than NBR data which did not fully record bonded imports from India.

Quantifying economic costs and benefits of an FTA

- A methodology was developed to quantify, by using industry case studies, the economic welfare implications of an FTA between the two countries. Free trade agreements discriminate against imports from rest of the world (ROW) and, in so far as the imports from the ROW countries that are excluded, are traded at lower prices than the imports from the FTA countries, there is an economic welfare loss for the FTA members, and also an economic loss for the ROW exporters who lose their markets. These trade diversion effects need to be allowed for in any comprehensive evaluation of the costs and benefits of FTAs.
- The following industry case studies simulated the likely effects of an FTA: cement, light bulbs, sugar, readymade garments. For the first three, it turned out that under an FTA there are expanded Indian exports to Bangladesh, but no exports from Bangladesh to India. This was because (a) India was exporting all these products to the rest of the world and –except for cement -- also to Bangladesh; and (b) Indian export prices were substantially lower than ex-factory before-tax prices of the same or similar products in Bangladesh. The simulations for ready made garments predict increased Bangladesh exports to India, but also increased RMG exports from India to Bangladesh.

Policy implications of FTA

Implications for Bangladesh. The static simulation results show export expansion for India in all products except garments. In these instances, consumer welfare gains far outweigh losses in government revenue or producer surplus in Bangladesh. But these gains could be extremely limited unless infrastructure and administrative capacities are expanded at the borders. Yet, by providing a captive protected market to Indian suppliers under an FTA, the possibility arises of collusion amongst Indian producers or between them and Bangladeshi importers, thus shaving off some of the welfare gains. Bangladesh would be better served in pursuing similar welfare gains from multilateral liberalization.

Implications for India. India's trade with Bangladesh is rather small relative to its total trade such that the economic welfare gains from an FTA are modest, largely stemming from gains in producer surplus due to expanded exports. Even in the RMG case, consumer gains are limited thanks to the general openness of India's current trade policies. India stands to gain from the continuation of its policies of unilateral liberalization paying special attention to the removal of non-tariff barriers, specific duties on textiles and garments, and prohibitive tariffs on agricultural products.

India-Bangladesh cooperation in other areas. The arguments against FTA and in favour of multilateral liberalization notwithstanding, immense possibilities exist for gainful bilateral economic cooperation. The study finds substantial benefits from coordinated improvements in the transport, storage and administrative infrastructures at and adjoining the India-Bangladesh land borders, as well as in harmonization and cooperation in Customs administration and banking relationships. Finally, there is little doubt that regional cooperation in energy and infrastructure could yield dividends in terms of cross-border investments and joint ventures.

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