

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.