

## 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 investments<sup>1</sup>.

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

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<sup>1</sup> 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 posts<sup>2</sup>.
- 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

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<sup>2</sup> 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.

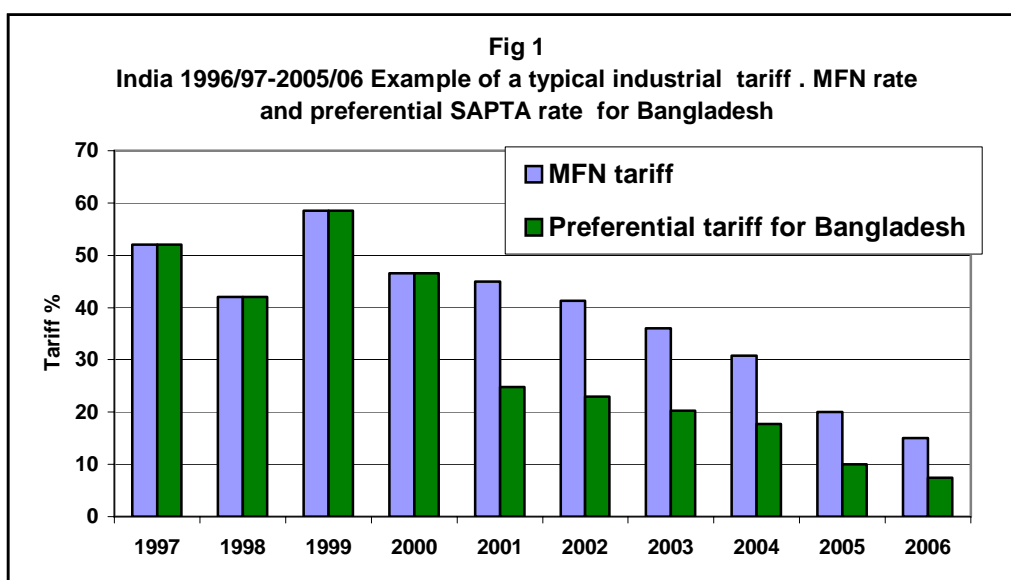
This issue is also considered in the consultant studies in the light of what is likely to happen were there free trade between India and Bangladesh. The general finding of the studies is that some aspects of India's import regime are retarding Bangladesh exports, but that in the short and medium run 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 DEPB<sup>3</sup>-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.

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<sup>3</sup> 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..

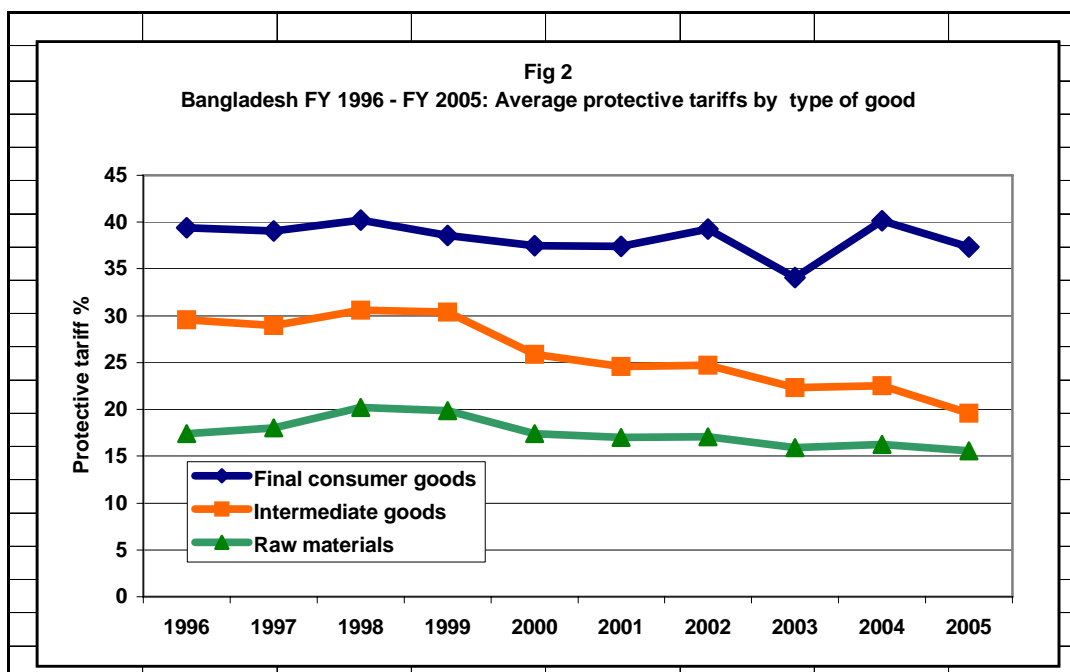
**Customs clearance at land border Customs posts** The land border trade is subject to very serious administrative constraints in Bangladesh, because 38 out of the 42 land border Customs posts with India severely restrict the imported goods that can be cleared, and only four land border posts can clear 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 SAFTA<sup>4</sup>, which takes effect from January 2006. Under SAFTA, the preferential tariffs agreed in the various rounds of SAPTA<sup>5</sup>-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

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<sup>4</sup> 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).

<sup>5</sup> 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.