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IMPLEMENTING THE SOUTH ASIAN FREE TRADE AGREEMENT (SAFTA): CHALLENGES AND POSSIBLE ROADMAP

Abstract

The members of the South Asian Association for Regional Cooperation (SAARC) established the SAARC Preferential Trading Arrangement (SAPTA) in December 1995. More recently, in January 2004 the SAARC member states signed the South Asian Free Trade Agreement (SAFTA) which will enter into force on January 1, 2006. Deeper economic integration is being pursued in South Asia to reap the benefits from enhanced levels of intra-regional trade and investment flows.

An analysis of the SAFTA Agreement reveals some major deficiencies which, if not rectified very quickly, may substantially reduce expected benefits from establishing a free trade area. These shortcomings of the Agreement have taken the form of a relatively slow tariff liberalization program; gray areas in provisions relating

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to non-tariff and para-tariff barriers; absence of negotiating modalities and deadlines with regard to concretizing rules of origin criteria; an apparent lack of consensus on issues of 'sensitive lists', revenue compensatory mechanism for LDC members, technical assistance for LDC members, and harmonization of legislation; and absence of provisions to deal with unfair trade practices and investment promotion.

A roadmap has been suggested for effective implementation of SAFTA. The policies suggested are: acceleration of the trade liberalization program, phasing out of non-tariff and para-tariff measures by a specified date, negotiation and incorporation of rules of origin criteria in the Agreement before it comes into force, negotiating the 'sensitive lists' in a WTO-consistent manner, designing an unambiguous revenue compensatory mechanism and ensuring technical assistance for LDC members, and incorporating provisions for dealing with unfair trade practices and promoting intra-regional investment.

I. The Context

The classical reason for gains from trade is that global free trade allows consumers and firms to purchase from the cheapest source of supply, ensuring that production is located according to comparative advantage. In the process, global real income and welfare is maximized. In contrast, trade barriers discriminate against more efficient foreign producers in favour of less efficient domestic producers, thereby curbing imports and inducing an expansion of inefficient domestic production. Such switching of production from goods that a country can produce efficiently to those it cannot reduces real income and welfare.

A well-crafted regional trade agreement (RTA), which aims at regional trade (and investment) liberalization to enhance intra-bloc trade, can raise efficiency and economic welfare in its member countries by facilitating consumer choice and increasing the

competition that producers face¹. Consequently, RTAs have been formed in different parts of the world, with a spurt in their formation occurring since the mid-1990s.

Since an RTA liberalizes trade, lowering at least some of the barriers, can it be said that it too will generate unambiguous gains from trade? The answer is in the negative. A partial and discriminatory reduction in barriers, as occurs in an RTA, simply shifts discrimination between sources of supply and does not eliminate it. Thus, if partner country production displaces higher-cost domestic production, there will be gains from 'trade creation'. On the other hand, it is also possible that partner country production may displace lower-cost imports from the rest of the world, resulting in 'trade diversion'. If trade diversion predominates across the board, then an RTA can reduce welfare in all member countries².

The above analysis is based on a view of the world in which inter-country trade is driven entirely by differences in productivity and factor endowments. But, in fact, trade can also arise from product differentiation and from economies of scale that reduce costs as production grows³. In these circumstances competition between firms is weakened, and consumers lose. International trade then offers an important means of increasing competition by allowing new suppliers to enter markets.

¹ But it can easily end up adding rather than removing distortions to trade and efficiency.

² The customs union issue was first analyzed by Viner (1950). For a rigorous analysis of the RTA issue see, for example, Robson (1998) and Schiff and Winters (2003).

³ This is the conclusion of the so-called 'new trade theory'. In this regard, see Krugman (1990 & 1994), Ventura (1997), and Grossman & Helpman (1991).

RTAs, by fostering trade between members, can generate such benefits because of the combination of larger firm size (which increases economies of scale) and a larger number of firms (which increases competition). This is the so-called pro-competitive effects of an RTA. Associated benefits would include a greater variety of products which increases the range of consumer choice, and elimination of internal inefficiencies (so-called X-inefficiency) of firms resulting in a rise in productivity levels (Horn, Lang, and Lundgren 1995).

On the empirical side, the conclusions from CGE models are, broadly, that there are gains from regional integration but that these gains are small (Francois and Shiells 1994; Harrison, Rutherford, and Tarr 1996). It should be noted that CGE models have a major weakness: they are not fitted to data as carefully, or subject to the same statistical testing, as econometric models. This weakness tends to bias CGE models toward finding benefits from RTAs (Schiff and Winters, *op. cit.*).

The small size and relatively closed structure of many developing countries mean that there is scope for more fully exploiting economies of scale and for removing local monopoly power (particularly in the services sector). This suggests that potential competitive gains from an RTA may be larger for developing countries compared to high-income economies.

Using CGE model, a number of studies have calculated the potential (rather than actual) gains that might be expected from the competition and scale effects. A study of MERCOSUR (Flores 1997) suggests GDP gains of 1.8, 1.1, and 2.3 per cent for Argentina, Brazil and Uruguay, respectively. Quite different results are obtained by Dissou (2002), who uses a similar methodology to examine the

effects on Senegal of the West African Economic and Monetary Union (UEMOA), an RTA of small least-developed countries. Improved regional market access raises Senegal's welfare by 0.15 per cent, which does not offset the welfare loss of 0.18 per cent from trade diversion. The small size of the welfare gain is likely to be attributable to the small intra-bloc trade flows.

There is virtually no direct *ex post* evidence on the competitive effects of RTAs among developing countries. Indirect evidence, however, shows that these gains depend largely on the existence of complementary production between members and on inter-industry trade. Although analysis of the importance of inter-industry trade in developing country RTAs is fragmentary and partial, simple statistics show strongly that developing countries, even in the middle-income range, generate far lower levels of such trade than do developed ones.

Regional integration schemes may thus offer developing countries substantial potential gain through competition and scale effects. The gains, however, are not automatic, and making sure that they are achieved calls for careful policy design. In particular, it requires easing barriers to entry (for example, for foreign direct investment) and allowing competition free rein even when it hurts.

The SAARC Preferential Trading Arrangement (SAPTA) became operative in December 1995. In 1996 SAARC member countries agreed in principle to go a step further and set up a South Asian Free Trade Agreement (SAFTA) by 2000, but no later than 2005. The Group of Eminent Persons (GEP) Report recommended a more gradual move from SAPTA to SAFTA with a target date of 2008. The GEP also envisaged the setting up of SAFTA as the first

step towards establishing a South Asian Economic Union (SAEU) by the year 2020.

The scheduled date of implementation of SAFTA was set at 2005, but this date was shifted forward to 2001 in the SAARC Summit in the Maldives in May 1997. Finally, the Agreement on SAFTA was signed in the Twelfth SAARC Summit held in Islamabad in January 2004, and the treaty shall enter into force on January 1, 2006. Thus, implementation of SAFTA has been delayed by five years, thereby reducing its trade-creating value not only in the context of multilateral trade liberalization under the WTO but even in relation to regional trade liberalization in South Asia.

The declaration of the Twelfth SAARC Summit views the signing of the SAFTA as "a major milestone." It is expected that SAFTA would enhance trade and economic cooperation by removing trade barriers among member states. The Summit also brought closer the region's two nuclear-armed rivals, India and Pakistan, in an apparent peacemaking process, which is important for the success of any economic cooperation effort in the region. It may be noted that the 12th Summit was delayed by one year as a result of acrimony between the two neighbors.

In its meeting in New Delhi in March 1997 the GEP had highlighted the potential benefits of closer economic cooperation in South Asia. The GEP's optimism was based on the fact that South Asian countries share many common economic, social, and cultural characteristics, geographical proximities, and shared languages. Production for a market of about 1.3 billion people will increase the international competitiveness of South Asian countries. The benefits of economies of scale will be available to all countries, particularly to the smaller economies, and this will help in attracting investment-

domestic, regional, and foreign⁴. Also, it is expected that the bargaining power of South Asian countries in multilateral negotiations will increase as a result of formation of a closely-knit economic bloc such as the SAFTA.

The objective of this paper is to examine the extent to which the SAFTA, as it stands, will be able to enhance trade among the SAARC nations in the manner expected⁵. The first step towards achieving this objective is to analyze intra-regional trade performance under the ambit of SAPTA in order to identify the problems and constraints which may be faced and should be avoided once implementation of SAFTA begins in 2006; this task is performed in Section II of the paper. Section III is devoted to a critical analysis of the SAFTA with the aim of identifying weaknesses and deficiencies in it. In Section IV a roadmap for achieving effective and meaningful implementation of the SAFTA is presented, based on the analysis contained in Sections II and III. The roadmap contains some specific and concrete proposals for amending the Treaty in certain areas, which should enhance its effectiveness in promoting trade in the South Asian region. Concluding remarks are presented in Section V.

II. Experience with SAPTA

SAPTA was signed in Dhaka on April 11, 1993 during the Seventh SAARC Summit and it entered into force from December 7, 1995, that is, ten years after SAARC was set up. Under the First Round of Trade Negotiations under SAPTA, altogether 226 items were offered by member states for preferential trading. The size of

⁴ As noted above, such benefits are far from certain.

⁵ There is no presumption in this paper that regional trade liberalization should be given precedence over multilateral or unilateral liberalization.

tariff concessions varied from country to country; the bulk of the concessions offered were on raw materials: wood and rubber products by India, vegetable and chemical products by Pakistan, and base metals by Sri Lanka. The issue of non-tariff and para-tariff measures was not addressed in the negotiations, and they continued to restrict trade as in pre-SAPTA times.

The Second Round of negotiations was concluded in November 1997. Tariff concessions were offered on 1871 items. The Third Round was operationalized from June 1999. 3456 tariff lines were covered in this Round. Despite the apparent progress made in SAPTA negotiations, the actual trade impact on the region's economies was very small. This is evident from Tables 1 and 2 given below.

Table 1 : Intra-SAARC Trade

Year	Intra-SAARC Trade (US\$ million)	World Trade of SAARC Countries (US\$ million)	Share of Intra-SAARC Trade in World Trade of SAARC Countries (%)
1980	1210	37885	3.2
1985	1054	44041	2.4
1990	1584	65041	2.4
1995	4228	104159	4.1
1996	4914	111479	4.4
1997	4390	115961	3.8
1998	6073	121331	5.0
1999	5471	126095	4.3
2000	5846	141708	4.1
2001	6495	140477	4.6

Source: IMF, *Direction of Trade Statistics Yearbook*, different issues

Table 1 shows that the volume of pre-SAPTA trade (*i.e.*, for the period 1980 to 1990 in the table) has been very limited, averaging less than 2.5 per cent of global trade of SAARC countries. Thus,

historically the SAARC member countries have not been trading among themselves to any significant extent. This demonstrates that while geographical proximity may facilitate trade through reducing transportation costs, this by itself is not enough to create trade. Other factors, for example complementarities in production and consumption, are more important in determining trade flows. In any case, the data seem to indicate that SAARC member countries may not be "natural trading partners".

SAPTA became operational in December 1995. Table 1 shows that during the period 1995-2001, the share of intra-SAARC trade in world trade of SAARC countries increased from 4.1 per cent to 4.6 per cent without any trend, indicating the negligible impact of SAPTA on intra-SAARC trade. Let us compare this with the trade effects of some regional trade arrangements (RTAs) between developing countries one year before and five years after implementation of internal tariff preferences. It is found that intra-bloc import share increased from 14.5 per cent to 20.2 per cent in MERCOSUR (Common Market of the South), 9.1 per cent to 12.6 per cent for CACM II (Central American Common Market), 6.8 per cent to 13.6 percent in Andean Pact II, 15.9 per cent to 17.7 per cent in AFTA (ASEAN Free Trade Area). It is also important to note that pre-union trade levels, usually considered as an indicator of the expected gains to be had from regional integration, in these RTAs were much higher than in the case of SAARC countries.

Table 2 : Country-wise Percentage Shares of Intra- SAARC Trade

Country	Share of Intra-SAARC Export in Total Export (%)		Share of Intra-SAARC Import in Total Import (%)		Share of Intra-SAARC Trade in Total Trade (%)	
	1995	2001	1995	2001	1995	2001
Bangladesh	2.8	1.8	18.4	15.4	13.3	10.4
India	5.0	5.4	0.5	0.8	2.6	2.9
Maldives	22.0	43.4	17.5	27.1	18.2	29.7
Nepal	8.7	27.1	20.6	40.3	18.1	35.9
Pakistan	3.1	2.9	1.1	2.6	1.9	2.8
Sri Lanka	2.7	3.3	10.3	12.0	4.0	4.5
SAARC	4.4	4.9	4.0	4.4	4.1	4.6

Source: IMF, *Direction of Trade Statistics Yearbook 2002*

Table 2 shows that intra-SAARC exports accounted for 4.6 per cent of SAARC export to the world, while the corresponding share of intra-SAARC import was even lower at 4.1 per cent in 2001. The share of intra-SAARC import for the two largest economies in the region – India and Pakistan – has been disproportionately low at 0.8 per cent and 2.6 per cent, respectively, of their import in 2001. When we examine changes in trade share with the SAARC countries after implementation of the SAPTA agreement, we observe that smaller economies, viz., Maldives, Nepal and Sri Lanka have substantially increased their trade share with SAARC countries. In contrast, intra-SAARC trade of India, the largest country in the region, remained virtually unchanged. Although import share of Pakistan from other SAARC countries increased since 1995, its export share to SAARC

countries actually declined⁶. Hence, bilateral imbalance in the region has emerged as a contentious issue. Because of its special trading relationship with India, Nepal's intra-SAARC export and imports are significant. Bangladesh has the highest share of intra-bloc import, while its share in intra-regional export is the lowest in the region. Consequently, Bangladesh has the largest intra-regional trade deficit.

A weakness of the foregoing analysis of intra-SAARC trade flows is that country-wise changes in intra-bloc trade volumes before and after formation of SAFTA have been wholly attributed to lower trade barriers achieved under SAPTA⁷. In reality, of course, a significant proportion of the observed changes in intra-regional trade flows is likely to have been caused by factors other than tariff preferences obtained under SAPTA. The implication of this is that the trade creating effect of SAPTA has been actually less than what Tables 1 and 2 seems to indicate.

The prospects for regional integration in South Asia have been examined in a number of empirical studies (De Melo *et.al.* 1993; Srinivasan and Canonero 1993; Srinivasan 1994; Rajapakse and Arunatilake 1997; Pigato *et. al.* 1997). The results of these studies are mixed in terms of the costs and benefits of regional economic integration in South Asia. While some studies seem to suggest that the smaller countries will benefit, this is not found to be true in other studies. Most studies however suggest that unilateral liberalization is likely to prove to be more beneficial.

⁶ Rahman and Rahman (2001) show that there had been rapid growth of Indo-Bangladesh trade in the 1990s for reasons mostly unrelated to SAPTA. Impact of SAPTA on intra - SAARC trade will be even lower if we consider such factors.

⁷ This weakness can be easily overcome by focusing solely on trade flows occurring under SAPTA (rather than intra-SAARC trade in its entirety). Lack of easy availability of data on trade taking place under SAPTA however precludes such an analysis.

Several factors have operated in concert to limit intra-SAARC trade flows. These include: (a) low complementarities of production structure of the region's economies resulting from similar comparative advantage; (b) low volume of pre-SAPTA trade; (c) relatively restrictive trade policy regime of SAARC countries; (d) actual trade coverage of preferences has been narrow as countries have offered concessions only on those products which do not have much trade value; (e) existence of para-tariff and non-tariff barriers; (f) tariff concessions offered under SAPTA have not been substantial, average tariff preferences offered ranging between 5% - 25% for non - LDC members, and 10% - 75% for LDC members; (g) weak economic infrastructure in terms of transportation, communication, energy etc.; (h) lack of necessary institutional services including banking, insurance, documentation, and trade information; and (h) opportunities for "fast track liberalization" (*i.e.*, liberalization across sectors) have been avoided. These economic constraints have been reinforced by political constraints. Bilateral disputes have often created an environment of mutual mistrust and suspicion among SAARC member states which have impeded cooperation.

The low level of intra-SAARC trade is thus partly a result of policy and partly stems from structural similarities⁸. This greatly reduces the potential for trade based on comparative advantage. The low per capita income level and small size of the manufacturing sector in member countries also restrict the potential for intra-industry trade where benefits of scale economies can be reaped. On the other hand, the weak liberalization efforts observed during the

⁸ These would include relative labour abundance, comparative advantage in similar commodities, agriculture based economy with a relatively small industrial sector (with the exception of India), low levels of income, etc.

three rounds of SAPTA negotiation point to a lack of political commitment to regional cooperation in the SAARC region.

Thus, both political and economic constraints have to be overcome to ensure the success of SAFTA. Political attitudes have to be changed from one of mistrust to that of cooperation and shared growth. The pace of trade liberalization needs to be accelerated. Transport and communication networks have to be developed in the region. Regional trade facilitation measures have to be adopted to ensure faster movement of goods.

III. The SAFTA Agreement : Some Deficiencies

The SAFTA Agreement shall enter into force on 1st January 2006 and shall supercede the SAPTA Agreement. It has a 10-year period for full implementation. The Agreement lays down very clear provisions on some issues including: (a) tariff reduction (Article 7); (b) procedural aspects of the application of balance of payments measures (Article 15) and safeguard measures (Article 16); and (c) a dispute settlement mechanism (Article 20).

The treaty has laid down a clear path for tariff reduction in its Trade Liberalization Program, which spans 10 years, beginning 2006. Internal tariffs will be reduced to zero in two phases by 31st December 2012 for non-LDC members and 31st December 2015 the LDC members. It may be noted here that according to the Uruguay Round tariff reduction schedule, the weighted average level of tariff applicable to industrial products was scheduled to fall by 1st January 2000 in the following manner: (i) 6.3% to 3.8% in developed countries; (ii) 15.3% to 12.3% in developing countries; and (iii) 8.6% to 6% in the transitional economies. The average tariff was to be reduced by 40 per cent by developed countries and 30 per cent by developing countries and transitional economies in a period of five

years (from 1st January 1995 to 1st January 2000). Assuming that multilateral tariff reduction under the WTO takes place at the pace noted above for the next 12 years from 2001 to 2012, average industrial tariff in the developed countries would be close to zero by 2012. The implication of this is that SAFTA would have little value for additional trade creation for SAARC member states if the pace of tariff liberalization is left unchanged as incorporated in the SAFTA Agreement. For making SAFTA more meaningful, the speed of tariff reduction must be accelerated from what it is now.

There are some gray areas in the SAFTA Agreement that need to be addressed immediately (or in the very near future) to ensure its effective functioning. These flaws are noticed in the provisions in the treaty relating to non-tariff and para-tariff measures, and rules of origin (ROO). The issue of non-tariff and para-tariff measures has been addressed in Article 7(4) wherein it is stated that members “shall notify the SAARC Secretariat all non-tariff and para-tariff measures to their trade on an annual basis.... The Committee of Experts shall recommend the elimination or implementation of the measures in the least trade restrictive manner.....” There are two problems with this provision. First, member countries will be tempted to continue using these measures since “least trade restrictive manner” is nebulous and does not impose any definite discipline on their use; for meaningful trade liberalization to occur, such measures must be eliminated altogether, except otherwise permitted under GATT 1994. Second, a definite time-frame for elimination of such measures is absent in the Agreement; such a time-frame (the shorter the better) must be set in order to facilitate intra-SAARC trade.

Article 18 deals with ROO. It states that ROO "shall be negotiated and incorporated in this Agreement as an integral part." The treaty makes no mention of negotiating modalities or deadlines, probably reflecting the inability of member states to reach concrete consensus on this issue. The absence of negotiating modalities and deadlines will create complications in the actual implementation of the Agreement unless the proposed action is completed before the implementation of the Trade Liberalization Program⁹.

Some deficiencies in the treaty also arise out of the inability of member states to reach consensus on the issues of (i) Sensitive Lists, (ii) revenue compensatory mechanism for LDC member states, (iii) technical assistance for LDC members, and (iv) harmonization of legislation. This is discussed below.

The issue of Sensitive Lists is addressed in Article 7.3 (a) & (b). According to the SAFTA Declaration, the Sensitive Lists "shall be negotiated..... and incorporated in this Agreement as an integral part. The number of products in the Sensitive Lists shall be subject to a maximum ceiling to be mutually agreed" However, the deadline for negotiation of Sensitive Lists has not been set, and the maximum ceiling on the number of products to be included in the Sensitive Lists has not been finalized. Needless to mention, the provision for Sensitive Lists will erode the effectiveness of tariff reductions. The number of products to be included in the Sensitive Lists should be

⁹ A major worry for members of any free trade agreement (FTA) is trade deflection, that is, the redirection of imports from non-member third countries through the FTA member with lowest external tariff. The usual solution is 'rules of origin' which specify domestic content requirements for one member's exports to qualify for duty-free access to other member's markets.

kept as low as possible for achieving meaningful liberalization and also for reducing trade deflection.

The issue of revenue compensatory mechanism is addressed in Article 11 (e), wherein it is stated that, “.....Contracting States agree to establish an appropriate mechanism to compensate the Least Developed Contracting States for their loss of customs revenue. This mechanism and its rules and regulations shall be established prior to the commencement of the Trade Liberalization Program (TLP).” Here a deadline for completion of negotiations has been specifically mentioned, that is , rules and regulations are to be finalized before SAFTA is formally launched in January 2006. However, the issue of what will constitute an ‘appropriate’ compensatory mechanism has been left open.

The issue of technical assistance for LDC members is addressed in Article 11(2). It is stated that, “A list of possible areas for such technical assistance shall be negotiated and incorporated in this agreement as an integral part”. Thus, while the need for technical assistance for LDC members has been accepted in principle, specific details are yet to be worked out in concrete terms. This reflects a lack of consensus, and the fact that no deadline is mentioned for negotiations to be completed introduces an element of uncertainty.

The issue of harmonization of legislation is addressed in Article 8 titled “Additional Measures” to support and complement SAFTA. Wording of the provisions is rather vague and appear to reflect a lack of consensus and perhaps also a lack of commitment; for example, “agree to consider” and “may include” are very weak statements of intention. The issues covered by this Article deal primarily with trade facilitation measures like harmonization of standards, mutual recognition and accreditation, simplification and harmonization of

customs procedures, etc., all of which are important for expediting trade flows¹⁰. No deadline has been set for completion of negotiations in this area.

Article 3(2)(f), which deals with the special needs of LDC member states, is ambiguous. The Article states that the special needs of LDC members would be "recognized by adopting concrete preferential measures in their favor on a non-reciprocal basis." Due to the lack of any negotiating deadlines, and because the special needs of LDCs have not been identified, this provision suffers from ambiguity.

The treaty has no concrete provision to deal with unfair trade practices like dumping and export subsidization; consequently, there are no rules relating to the use of anti-dumping and countervailing duties. Moreover, the Agreement does not contain rules and regulations relating to technical barriers to trade, and sanitary and phytosanitary measures. These issues are very pertinent while a region moves to a free trading arrangement. There is precious little on investment promotion in the Agreement except in Article 8(h), which states that barriers to intra-SAARC investments shall be removed to support and complement SAFTA. It is important to note here that trade generally follows investment. Trade volumes cannot increase significantly in the absence of intra-regional investment flows. Scanty intra-regional investment flows was one of the major reasons behind the weak trade creating effect of SAPTA. Hence, for SAFTA to become effective in enhancing intra-SAARC trade, there is a need to work out a regional arrangement for investment promotion as well as protection.

¹⁰ For a good review of the importance of trade facilitation in enhancing trade at both the multilateral and regional levels see, for example, Staples (2002).

IV. EFFECTIVE IMPLEMENTATION OF SAFTA : A POSSIBLE ROADMAP

Several specific issues deserve special attention to ensure that SAFTA achieves its desired goal of significantly augmenting intra-SAARC trade. These issues have been highlighted in Section III above. In this Section, a possible roadmap, focusing on changes/amendments/additions which need to be made to the SAFTA Agreement as it stands at present, is presented which would hopefully enable SAFTA to attain its professed objectives.

(a) Trade Liberalization Program (TLP)

According to the SAFTA Agreement, internal tariffs are to be phased out by 31 December 2012 for non-LDC members, and 31 December 2015 for LDC members. As already pointed out in Section III, if multilateral tariff reductions under the WTO continues at the same pace as in the Uruguay Round, then the average tariff on industrial products in developed countries (which are the major markets for exports from SAARC countries) would be very close to zero by 2012, thereby making SAFTA virtually redundant. This implies that the TLP must be appreciably speeded up if SAFTA is to deliver its desired trade benefits.

A similar conclusion is reached if one examines the tariff reduction schedule in some of the bilateral agreements in South Asia¹¹. Under the India-Sri Lanka bilateral FTA, Sri Lanka would be able to have duty-free access to the Indian market by 2003; on the other hand, India will have duty-free access to the Sri Lankan market for her exports by 2008. The Pakistan-Sri Lanka bilateral FTA, which has already been finalized, has tariff phase-out dates that

¹¹ See Kelegama (2002).

coincide with the India-Sri Lanka FTA. The implication is that the tariff phase-out date under SAFTA for non-LDC member states should not be later than 2008, if SAFTA is to be meaningful.

In the light of the above analysis, it is proposed that the tariff phase-out date under the TLP of SAFTA should be brought forward from 31 December 2012 to 31 December 2008 for non-LDC member states. Giving LDC member states two more years for reducing internal tariffs to zero, the tariff phase-out date for LDC members should be brought forward to 31 December 2010 from 31 December 2015. The TLP implementation period will therefore be reduced from ten to five years. Incidentally, these were the tariff phase-out dates recommended by the GEP Report (of course, it was recommended that the SAFTA Agreement be implemented from 2000). This means that tariffs would have to be reduced annually at 33.33 per cent by non-LDC members, and 20 per cent annually by LDC member states.

(b) Phasing out of non-tariff and para-tariff measures

The GEP Report has recommended that all non-tariff barriers (NTBs) are to be identified during the first year of implementation of the Agreement and phased out by 2008 for non-LDC member states and 2010 for LDC member countries. We propose that this time - frame be strictly adhered to in the identification and phasing out of non-tariff and para tariff measures. Furthermore, the provision in Article 7(4) should be modified to read, "The Committee of Experts shall recommend the elimination of the measure in order to facilitate intra-SAARC trade"; that is, the words "or implementation of the measure in the least trade restrictive manner" should be deleted.

(c) Rules of origin (ROO)

It is proposed that the ROO should be negotiated and incorporated in the Agreement before implementation of SAFTA

begins on 1 January 2006. Otherwise, the process of trade liberalization may be seriously hampered. Furthermore, it may be noted that in case of SAPTA, the ROO requirements stand at cumulative value addition of 40 per cent for non-LDC member states and 30 per cent for LDC members. But these have proved to be relatively trade restrictive. On the other hand, potential trade deflection is an important concern which needs to be addressed under SAFTA. To achieve a balance between trade deflection concerns and the trade-restrictive effect of ROO, it is proposed that the ROO requirement under SAFTA should be fixed at cumulative value addition of 30 per cent for non-LDC members and 20 per cent for LDC member states¹².

(d) Sensitive Lists

The SAFTA Agreement was signed on 6 January 2004 and will come into force on 1 January 2006. So the deadline for negotiations on Sensitive Lists should be set on 31 December, 2005. This would provide member countries nearly two years for ratification of the Treaty and working out the Sensitive Lists. Furthermore, the maximum ceiling on the number of products to be included in the Sensitive Lists should be determined in a manner such that it is consistent with the WTO rule that an RTA must cover "substantially all trade" in the region¹³.

¹² Rules of origin may also result in trade diversion by creating an incentive for producers in one partner to purchase higher-cost inputs from another even though cheaper inputs can be had from the rest of the world. Rules of origin can also artificially increase domestic sales if the favoured input is domestically produced.

¹³ Article XXIV of the GATT allows FTAs and customs unions if (a) trade barriers after integration do not rise, on average; (b) all tariffs and other regulations of commerce are removed on substantially all intra-regional exchanges of goods within a reasonable length of time; and (c) the arrangements are notified to the WTO Council.

(e) Revenue compensation for LDC member states

Many developing countries, particularly LDCs, are heavily dependent on trade taxes as a source of revenue. Membership in an RTA erodes these revenue- directly, as tariffs on intra-bloc trade are reduced (to zero in the case of an FTA), and indirectly, when trade diversion occurs, as importers switch away from non-member country imports subject to tariffs (in this case, the revenue is transferred to partner producers). In such a situation, either the revenue-losing member has to take steps to improve the take from domestic excise, sales, or value-added taxes, or it has to be compensated (by other members) for the revenue loss.

Mukherji (2000) has estimated total revenue loss from trade liberalization under the three rounds of SAPTA negotiations to be US \$ 9.2 million. Given the limited concessions under SAPTA, revenue losses to date have been small. However, in the context of more substantial liberalization which is expected to occur under SAFTA, revenue losses will be larger particularly in the short term. Under these circumstances, LDC members who already face serious resource constraints, will be compelled to reduce social sector and other spending which may have adverse effects on poverty alleviation. Since the scope of raising additional tax revenue (to offset the revenue loss resulting from SAPTA) is very limited in LDC member countries, these countries should be compensated for their revenue loss in the short term. In the longer term, the magnitude of revenue loss is likely to decline for at least two reasons : (a) the reduction in tariffs will over time increase economic growth and would stimulate imports; (b) if smuggling falls in response to lowering of trade barriers, and additional trade is routed through formal rather than informal channels, then tariff revenue would

increase. When this happens, the need for compensation would decline and may eventually be eliminated.

The revenue compensatory mechanism must be designed in clear and unambiguous terms. Following the recommendation made by the GEP Report, we propose that a regional compensatory fund like a South Asian Development Fund should be created with proportionate contributions from India and other trade-surplus member countries, and this Fund shall be used to undertake development projects in the revenue losing LDC member countries.

(f) Technical assistance for LDC member states

Negotiations on the possible areas for technical assistance to LDC member countries should be completed by 31 December 2005, that is, before the SAFTA Agreement comes into force. This will enable LDC members to overcome their supply – side constraints and thereby derive greater benefits from regional trade liberalization. In turn, the more equitable distribution of the benefits of liberalization will increase the political commitment of LDC members to regional integration.

(g) Harmonization of Legislation

Trade facilitation measures like harmonization of standards, mutual recognition and accreditation arrangements, simplification and harmonization of customs procedures, etc. are crucially important for promoting trade. Given their importance, the deadline for negotiations on these issues should be set on 31 December 2005. Elimination of these ‘invisible’ barriers to trade will complement the trade-expansory effects of removal of visible tariff and non-tariff barriers.

(h) Special needs of LDC member states

The negotiating deadline should be set on 31 December 2005. In identifying these special needs of LDC members, the following areas should be kept in mind: building up of their export supply capacity, duty-free and quota-free access to their exports by a date earlier than the full establishment of SAFTA, building up their transportation and communication network, relaxed ROO criteria, as so on.

(i) Unfair trade practices, technical barriers to trade, and sanitary and phytosanitary measures

The Agreement should be strengthened through incorporation of disciplines in these areas. Unless this is done as soon as possible, the effectiveness of SAFTA would be greatly reduced .

(j) Promotion of intra-regional investment

Policy measures that clearly link investment and trade are vital, since this is what sustains regional trade. Preferential treatment should be given to SAARC investors in member countries. Such preferential treatment may take the form of access to investment in particular sectors only to SAARC member countries on a reciprocal basis, as is done in the ASEAN.

(k) Transport and Communication

Development of transport and communication linkages in the South Asia region is urgently required to complement tariff liberalization with the objective of promoting intra-regional trade. Efforts have to be made to establish a Regional Transportation Network such as the Asian Highway Project and Trans-Asian Railway Project. Regional inland waterways need to be developed with special emphasis on transit facilities for land-locked Nepal and

Bhutan. There should be traffic movement cooperation in shipping and port arrangements such as centralized freight booking system, multimodal transport with containerization , etc.

V. Concluding Remarks

What the SAARC region has experienced till now can be termed as 'shallow regionalism.' Intra-SAARC trade flows have been meager, while intra-regional investment flows have been even smaller. A host of factors have militated against regional cooperation in South Asia, but among these, a distinct lack of political will stands out. The recent thaw in Indo-Pak relations augurs well for regional cooperation in the South Asia region.

The signing of the SAFTA Agreement has raised hopes about stronger regional economic cooperation. However, the Agreement suffers from some deficiencies and weaknesses, and if these problems are not addressed immediately the vision of free trade in South Asia may turn out to be a mirage. Whether the SAFTA Agreement is modified in time to unleash the forces of free trade in the South Asia region will ultimately depend on a shared vision of a prosperous South Asia and a strong political commitment to materialize this vision.

Discriminatory regional liberalization will not bring the same gains as non-discriminatory multilateral or unilateral liberalization since there is always the danger of trade diversion. The implication is that the SAARC countries should not lose sight of the final goal of multilateral liberalization in their quest for regional integration. Regional integration should be viewed as a 'stepping stone' towards achieving the ultimate objective of multilateral free trade, rather than as an end in itself. To be consistent with this, external tariff of SAFTA members should be kept at low levels and gradually

reduced, and the size of the 'sensitive lists' should be kept small. This will not only pave the way for faster multilateral trade liberalization which is urgently required in South Asia, but will also reduce the negative welfare effects of trade diversion which may result from SAFTA.

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