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BACKGROUND PAPER

**POLITICAL ECONOMY OF REGIONAL
INTEGRATION IN SOUTH ASIA**

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Abstract

Although it has been decades since the creation of the South Asia Association for Regional Cooperation (SAARC), regional integration in South Asia is still a long distance from priority for South Asian countries. The change in the world economic order and recent developments in South Asia make it pertinent to re-look at the case of integration in South Asia. This paper examines the political economic factors that have been impediments to economic integration in the region. It looks at regional integration arrangements in other parts of the world to identify key lessons for South Asia. Further, it also examines the role of legal instruments entered in South and Southeast Asia in the area of trade and investment towards regional integration. The paper emphasizes the need for a fresh look at the relevance of integration in the region. It also emphasizes the need to invigorate the SAARC so that it can meaningfully lead a multilateral process of regional integration in South Asia.

I. Introduction

South Asia comprises Bangladesh, Bhutan, India, the Maldives, Nepal, Pakistan and Sri Lanka. Afghanistan is the newest member of the regional bloc, having joined the SAARC in 2005. Despite common heritage, history, linguistic, cultural and social practices shared by these nations, South Asia has emerged as the least integrated region in the world. South Asia is distinctly characterized by complex security issues, multiple inter-state disputes and yet a high untapped economic potential. The challenges faced by the region are based deep rooted and historic differences. Consequently political issues and conflicts have not allowed economic and strategic interests to take precedence in matters of policy and development.

The regional trade in South Asia is dismally low at 4 percent as compared with the regional trade of the European Union at 67 percent, the North American Free Trade Agreement (NAFTA) at 62 percent, the Association of Southeast Asian Nations (ASEAN) at 26%, the Common Market for Eastern and Southern Africa at 22%, Gulf Cooperation Council at 8%, Latin America and Caribbean at 22% ¹. Regional trade among the seven SAARC countries in 2002 was US\$5 billion out of which India's share was 76 percent (US\$3.8 billion) and

¹ World Bank, *South Asia: Growth and Regional Integration*, Washington D.C, (2007). Intra-regional trade in South Asian countries, was at 19% of total trade in 1948, decreased to 2% by 1967 as governments adopted inward-looking policies along with high tariff and non-tariff barriers. The share increased during the 1990s due to the adoption of unilateral trade policy liberalization in the individual countries

Pakistan's share was 8 percent (US\$0.4 billion)². The regional trade among the remaining five countries is limited to around 16 percent (US\$0.8 billion) of the total regional trade.

Inspired by the success of economic integration agreements in other parts of the world South Asian countries decided to create the SAARC. The initial proposal of SAARC made by former president of Bangladesh, Ziaur Rahman, in May, 1980 was endorsed by Nepal, Sri Lanka, the Maldives and Bhutan. The rationale behind the proposal was to achieve stability, security and peace in the region. India and Pakistan's acceptance was hesitant, gradual and based on the condition of excluding security related and bilateral matters out of the scope of the proposed regional cooperation agreement. The charter of the SAARC was accepted by all the seven members in mid 1985. SAARC is the main vehicle for moving towards greater integration in the region. So far, SAARC has been an ineffective institution, vulnerable to regional politics and with inadequate capacities.

There is a divergence of opinions on the prospect of increasing economic integration in South Asia. Some authors argue that unilateral liberalization as is currently underway in South Asia offers greater benefits than regional integration would³. Others believe that regional integration will create exciting opportunities and will allow countries to develop comparative advantage, coordinate programs to address challenges in governance, environment, social development, and other areas that most often spill over national boundaries⁴. The objective of this paper is to analyse the political economic factors and challenges affecting regional economic integration⁵ in South Asia, incentives for increasing integration and finally to draw out lessons from the regional integration experiences in other parts of the world. Part II of the paper discusses the challenges in increasing integration in South Asia. Further, it also discusses the incentives and potential benefits of regional integration to the South Asian countries. In Part III, suggestions to increase economic integration have been made with particular reference to the ASEAN integration process. Part IV discusses the features, significance and limitations of trade and investment agreements in South Asia and the ASEAN region. Finally, Part V of this paper provides the concluding remarks.

II. Regional Integration in South Asia

1. Challenges to regional integration in South Asia

Several empirical studies have concluded that most of the preconditions required for successful regional integration are not present in South Asia⁶. A review of some of these studies suggests the following key challenges to regional integration in South Asia:

² World Bank, South Asia Growth and Regional Integration Report, Available at <http://siteresources.worldbank.org/SOUTHASIAEXT/Resources/223546-1192413140459/4281804-1192413178157/4281806-1265938468438/BeyondSAFTAFeb2010Chapter14.pdf>

³ Bandara, J.S. and W.Yu., How Desirable is the South Asian Free Trade Area? A Quantitative Assessment, The World Economy. 26 (9), (2003)

⁴ See UNCTAD and ADB, Quantification of Benefits from Regional Cooperation in South Asia, (2008)

⁵ In the general sense of the term, economic integration is the abolition of the various restraints on trade between nations. The four main stages of integration are establishment of free trade areas wherein tariffs between member countries are abolished, the establishment of a customs union, the setting up of a common market and complete economic integration through the unification of monetary and social policies.

⁶ The World Bank has broadly identified four conditions that significantly bring success in integrating a region. These conditions are : (i) the pre-free trade agreement (FTA) tariffs should be high; (ii) the

1.1 *Bilateral Relationships*

South Asia is perennially plagued with multiple intra region and intra state conflicts either on basis of geographic boundaries or narrow considerations of religion, caste, language or ethnicity. These conflicts have since decades been at the forefront of political and public life in SAARC states, causing economic development to almost always be a subservient objective. The region, rife with constant conflicts never provided the appropriate environment for supporting the efforts towards integration. The relationships between countries had some or the other historic baggage due to which they have still not been able to move ahead by burying their differences. For instance, despite a comparatively cordial relationship, India and Nepal have also had disputes. The provisions of the 1950 Treaty of Peace and Friendship obligated the governments of Nepal and India to consult with each other in devising effective countermeasures to meet security threats emerging out of foreign aggression. It also required the two governments to inform each other of any serious friction with any neighboring country that may be likely to adversely affect the ties between India and Nepal. This provision was resented in Nepal, since it restricted Nepal's autonomy and increased chances of Indian domination. Nepal also used its proximity with China as a strategy to move away from India. After the India-China war in 1962, Nepal allowed China to build the Lhasa-Kathmandu road. This move was interpreted by India as Nepal's acquiescence to China's presence and involvement in South Asia and a serious threat to India's security interests. Another issue between the two countries was regarding declaration of Nepal as a zone of peace which was supported by China but perceived by India as a move to distance itself from India⁷ and the commitment under the Treaty of Peace. Sri Lanka has no major dispute with most SAARC states. With India, its main dispute was regarding denial of citizenship to a large number of Tamils and their repatriation to India and India's interference in Sri Lanka's Tamil ethnic conflict since 1983. Sri Lanka accused India of providing training and supplying arms to Tamil terrorists. However, the relationship between the two countries has improved since India has shown support towards the Sri Lankan government's efforts to achieve peace. The recent vote by India against Sri Lanka at the United Nations Human Rights Council on the issue of accountability and violations in the civil war where the Tamil Tigers were defeated has affected the relations between the countries.⁸ Notably, Sri Lanka had approached China for support in the US led movement. China along with 15 other countries voted in favor of Sri Lanka on grounds that Sri Lanka is capable of managing its internal affairs. India and Bangladesh have unresolved issues regarding illegal migration from Chittagong Hill Tracts, sharing of waters and demarcation of boundaries. The pre-partition relationship between eastern and western Bengal, is still remembered bitterly in Bangladesh.

members of the FTA should be important trading partners before entering into an arrangement (iii) there should be complementarity in demand (iv) difference in economic structure should be based on the 'true' competitiveness of the countries involved. Except the first condition, South Asia in most cases does not satisfy the other conditions.

⁷ Apart from these issues, being bordering states, India and Nepal have existing issues regarding migration, border security and allegations of smuggling Indian goods across the borders and thus negatively affecting the Nepalese economy (Gurung Commission report of 1983).

⁸ The Indian government had to take this decision in order to retain support of its domestic allies. See "India votes against Sri Lanka" UN Human Rights Council Resolution adopted, March 22, 2012. Available at <http://www.ndtv.com/article/world/unlike-china-india-likely-to-vote-against-sri-lanka-for-alleged-war-crimes-188871>.

Over the years, such a conflict ridden atmosphere reinforced and even further escalated negative public attitudes towards other countries in the region, particularly towards India. Continued negative perception of each other has led to reluctant commitment towards regional integration⁹.

The region's overall instability is also a challenge. Apart from bilateral disputes, most South Asian nations are facing serious security threats from civil violence and intra state separatist and religious conflicts. For instance, India faces such movements in Punjab, Kashmir and in the eastern states of Mizoram, Assam and Nagaland. Further, greater commitment will be required by the Indian states neighboring SAARC countries (such as West Bengal) and an effort will have to be made to have these states think in national interest over short term provincial interest. Given the nature of Indian politics and recent episodes like the failure of the Teesta sharing agreement¹⁰, federalism may itself create certain challenges. Nepal's political system is constantly under Maoist threat. Often Sri Lankan governments have been close to a collapse due to the continued Tamil-Singhalese ethnic conflicts and failed economic reforms. Pakistan is currently immersed in a series of ethnic clashes. While such conflicts pose a challenge to integration, it will be discussed later in this paper that such an environment also creates opportunities for integration.

1.2 *India - Pakistan Relations*

Originating from the two nation theory¹¹ at the time of partition, the relations between India and Pakistan have remained strained, marked with insecurities on both sides. Attempts to ease the tension have failed numerous times and there remain several unresolved bilateral disputes, the biggest being the territorial dispute over Kashmir. Pakistan feared that if Kashmir, a muslim majority state remains a part of India, then the very *raison d'être* of Pakistan would collapse. India, on the other hand, feared that giving up Kashmir would undercut its secular construct and promote separatists tendencies. In the past six decades, the two countries have fought three wars over Kashmir, while low-level insurgency persisted and the relations were constantly turbulent between the two countries. In the late 1940s, trade between both nations as part of one political entity (i.e. British India) was sizeable. Even in 1947, when Pakistan (Pakistan then included Bangladesh) and India became independent, more than half of Pakistan's imports came from India and nearly two-thirds of its exports went to India. However, with growing disputes over security and territory, the trade between them declined. As the two largest nations in South Asia, the relationship between these two nations impacts the entire region.

1.3 *Lack of a common threat*

⁹ Dash K.C, Routledge Contemporary South Asia Series: *Regionalism in South Asia- Negotiating Cooperation*, Institutional Structures, London, (2008)

¹⁰ Mamata Bannerjee, the chief minister of the state of West Bengal in India refused to support the Teesta Water Sharing Agreement, which was a big step initiated by Prime Minister Singh towards improving bilateral relations between Bangladesh and India. See Sharma, Pranay, *Just Water in the Works*, Outlook India, May 21, 2012, Available at <http://www.outlookindia.com/article.aspx?280869>

¹¹ As per the two nation theory, primary identity of Muslims in the Indian subcontinent is their religion, rather than their language or ethnicity, and therefore Indian Hindus and Muslims are two distinct nationalities, regardless of ethnic or other commonalities.

Most successful instances of regional integration have been motivated by the need to protect against some external security threat. The threat may be regarding territorial, ideological or political dominance. For instance growing power of the Soviet Union in Eastern Europe and the emergence of the United States after 2nd World War was one of the considerations pushing Western Europe towards increased integration, even between previously adverse nations such as Germany and Italy. In the east, increased power and influence of China and communist regimes caused the smaller East Asian nations to come together to form ASEAN. In other regions as well, a common threat has caused the threatened nations to come together despite previous differences¹². In absence of such a significant threat, nations often find some reason to limit their efforts towards increasing integration. This is one big difference between the South Asian and the Southeast Asian experience. South Asia seems to, so far have lacked a common external threat which would bring together the constituent countries.

1.4 Protectionism

The economic policy of South Asian nations was based on the goal of self-sufficiency through import substitution. Increased trade within the region has been perceived as increasing dominance and dependence on India rather than as access to the large markets of India and Pakistan. Smaller states like Nepal and Bangladesh chose to import from suppliers outside of the region even at higher costs and showed considerable reluctance to accept Indian investments. Despite Nepal's potential hydropower capacity being greater than [70,000] MW and a continuing increase in India's demands, only 1% of this capacity has been developed by the two nations. Sri Lanka imports railway coaches from Romania when better-quality coaches are available at a much cheaper price in India (in the state of Tamil Nadu). Similarly, in cement and ship building, Sri Lanka can stand to gain by trading with Pakistan and India rather than South Korea. Pakistan in particular always aimed at diminishing its historical links with India and reducing any form of interdependence¹³. Over the years, increasing trade links with India has been subject to tough resistance from industry members and other hardliners. As discussed later in this paper, this position is slowly changing.

1.5 Lack of comparative advantage

South Asian countries trade little with each other but trade much with other nations of the world particularly with North America and Europe. The composition of each South Asian country's exports to these regions is almost similar. Textile, readymade garments, leather, agricultural products constitute a chunk of the export items while petroleum and capital intensive goods are mostly imported. Consequently, trade between South Asian countries is

¹² Other examples are: Concerns of Latin American nations over US hegemony led to the formation of Mercosur; fear of Iran and Iraq among the smaller Persian nations led to formation of Gulf Cooperation Council.

¹³ A study by the State Bank of Pakistan in 2005 found that 32% of the types of products exported by Pakistan were imported by India from countries other than Pakistan despite the price of Pakistani products being lower. Similarly, Pakistan also imported, at comparatively higher prices, nearly 50% of India's export products from other countries. The study estimated that Pakistan was losing between US\$400 million and US\$900 million annually by obtaining such imports from alternative sources. (cited in Desai V.V., *The Political Economy of Regional Integration*, Asian Development Bank, July 2010) Also see Taneja, N., *Trade Possibilities and Non Tariff Barriers to Indo-Pak Trade*, Working Paper No. 200, Indian Council for Research in International and Economic Relations, 2007.

likely to be more competitive rather than complementary. All the countries are rich in labor but strapped for cash. No one country has a significant comparative advantage over the other for specific items. India's economic prevalence and comparative advantage in a wide range of products has resulted in asymmetric trade relations with her neighbors. Further, until a few years back all countries were pursuing import substitution policies, which never allowed development of a particular area of expertise in the production chains.

1.6 Power Asymmetry and Geographic dependency

The biggest challenge to increasing integration in South Asia is the power asymmetry in the region. It would be relevant to refer to the power-centrist view on regionalism here. As per the power centrist view¹⁴, power, both military and economic, is the most critical determining factor in regional integration arrangements. Increased regional integration is often a response to a powerful state from outside the region if the actions of the external powerful state are perceived as a threat. Even if the powerful/hegemonic state is from within the region, the states in the region may consider integration and cooperation to moderate the exercise of power by the hegemonic state. According to this view, states will commit to integration only to the extent that it benefits their national interest. States are more likely to expand trade and cooperate with allies than with potential allies¹⁵. Further, perceived unequal distribution of gains among member states is also likely to limit cooperation unless measures to compensate the disadvantaged are put in place. Interplay of these theoretical ideas is seen in South Asia.

There is extreme asymmetry of power balance among the South Asian countries. While India accounts for 75% of SAARC's population and about 80% of GDP, the second and third largest member states account for only about 10% and 7% respectively¹⁶. India also has tremendous military power compared to all other SAARC members. This power asymmetry forms the basis of all apprehensions regarding increased integration of other (than India) South Asian countries. Another related factor is the geographical dependency of member states on India. India shares borders with all member states (except Afghanistan and the Maldives). Except Pakistan, no other member state shares a border with any country other than India. Nepal and Bhutan are land-locked and depend on India for transit to the outside world. Bangladesh has direct access to international seas from one side but is surrounded by India on all other sides. Bangladesh which was formerly part of eastern colonial India continues to remain dependant on the western Bengal which continues to be part of India.

These factors have caused India to be perceived as a threat by all the countries in South Asia. At the time of creation of SAARC and arguably till this date, relations of the other SAARC members with India have been fraught with distrust, hostility and apprehension. India joined the SAARC on the condition that security issues and bilateral issues would be kept outside the purview of the SAARC. Consequently SAARC became a forum for economic and trade related cooperation. However, since insecurities relating to India's dominance and historic bilateral differences remain the core concerns of SAARC members, all attempts towards

¹⁴ Desai V.V., *The Political Economy of Regional Integration*, Asian Development Bank, (July 2010)

¹⁵ Mansfield E and Bronson R., *The Political Economy of Major Power Trade Flows*, The Political Economy of Regionalism, Columbia University Press (1997)

¹⁶ World Bank South Asia Economic Update 2010, *Moving Up, Looking East*, Available at <http://siteresources.worldbank.org/SOUTHASIAEXT/Resources/223546-1269620455636/6907265-1275784425763/SAREconomicUpdate7June2010.pdf>

integration have been colored and largely unsuccessful. From India's perspective, economic cooperation agreements entered into by member states with countries outside the region were perceived as threats to its security and further diluted its commitment towards regional integration. India's also had the initial apprehension regarding SAARC that it may be an effort of the neighboring countries to gang up against India.

2. Incentives for increasing regional integration

There are multiple incentives for all South Asian countries to make efforts to increase integration. Benefits of integration vary depending on the stage in development and political position of each country. Following are some incentives common to all South Asian nations:

2.1 *Trade Facilitation*

Studies have shown¹⁷ that a big source of transaction costs in trade between India, Nepal and Bhutan are complex customs and transit procedures. Custom clearances which comprise detailed verification procedures, labeling and testing requirements cause significant delays. As a result of such delays and costs, parties have resorted to informal trade and thus caused losses in government revenue collection. Increased cooperation between member states will facilitate harmonization arrangements in areas such as customs procedures, arbitration, double taxation, access to market information and legal systems. Such arrangements will increase efficiencies in the region and make businesses more profitable. Article 8(a) of SAFTA provides for such harmonization. SAARC member countries have signed the Agreement on Establishment of South Asian Regional Standards Organization that provides for setting up of a South Asian Standards Organization. It would be interesting to see how this organization develops and the extent of effectiveness and efficiency it achieves. If the organization is effective and functions as is being proposed, it will also help reduce the administrative burden of national customs and standard setting organizations of the SAARC member states.

Another incentive for regional cooperation and integration is the possibility as a "regional bloc" of setting uniform standards for products and harmonizing such standards with similar international standards. As was the case with EU, common standards would bring South Asia in the mainstream global marketplace. Harmonizing standards by adopting best practices would increase reliability and meet health, safety and environment requirements and consequently lead to a larger market and greater international acceptance of South Asian products. A more integrated South Asia would also have a stronger voice in multilateral standard setting bodies.

Regional cooperation will facilitate trade by improving infrastructure and transport linkages. Not only will this make trading in the region easier, it will open other trade opportunities since the region is strategically situated at the crossroads of Asia between the oil-rich countries in West and Central Asia and the dynamic economies of Southeast Asia. The resource requirements for infrastructure development in South Asia are gigantic. In India alone, Planning Commission estimates put the resource requirement at \$500 billion for the

¹⁷ Pohit, S., and N. Taneja, *India's informal trade with Bangladesh and Nepal: A qualitative assessment*, Working Paper No. 58, Indian Council for Research on International Economic Relations, New Delhi, (2000)

next few years to meet the needs of growing population and rapid urbanization. Regional cooperation would create a larger market and offer multilateral agencies and the private sector attractive investment opportunities in developing the physical infrastructure in the region.

Due to reliance on theory of self sufficiency, trade complementarities never developed in the region. Vertical specialization would allow countries to reap economies of scale by concentrating on a specific production process in the value addition chain. For instance, one country can specialize in production of yarn while the other focuses on production of finished garments. In the South Asian context, Bangladesh having a booming jute industry can concentrate on production, while West Bengal (India) having processing mills could focus on production of fabric. This would be an effective way to benefit from economies of scale and expand the production base.

2.2 *Reduction of costs and benefits to consumers*

Regional cooperation and integration will allow the SAARC states to benefit from international investment, technology and trading opportunities. All nations will gain from more efficient use of capital and labor, distribution of goods and services across borders and increased FDI. There will be reduced prices for consumers due to reduction in overhead costs such as transportation costs. Currently the poor transport system within the region increases costs and time for trade within South Asia. It takes an Indian importer the same time to receive a shipment of fabric from Pakistan as it does from Europe. Costs are also made higher since importers have to re-route goods from other countries (e.g. auto tires from India supplied to Pakistan market via Dubai). Such costs will be avoided by increased regional cooperation and integration. Integrating smaller economies into larger regional economies will expand the size of the market and reduce costs through economies of scale. It will also make smaller markets more attractive since larger volumes of foreign investment could then be made.

2.3 *Access to larger markets*

Studies¹⁸ have shown that South Asia – East Asia integration will provide significant benefits for South Asia and East Asia. East Asia will benefit largely from the participation of India. South Asian countries (other than India) will benefit only if India takes its neighbours with it in the integration process. An East Asia-India relationship would likely benefit India more but leave behind other South Asian countries. A World Bank study¹⁹ shows that India's gain from a larger East Asia Agreement is more than its gain from a regional agreement within South Asia. On the other hand, the gains for other South Asian countries from a regional agreement in South Asia are more. India has been slowly deepening its trade and economic relations with the ASEAN states, China, Japan and Republic of Korea. It has signed a free trade agreement (FTA) with ASEAN. India has the potential of slowly becoming a bridge

¹⁸ Francois, Joseph, Ganeshan, Wignaraja, *Economic Implications of Deeper Asian Integration*, Centre for Economic Policy Research, (2008)

¹⁹ World Bank South Asia Economic Update 2010, *Moving Up, Looking East*, Available at <http://siteresources.worldbank.org/SOUTHASIAEXT/Resources/223546-1269620455636/6907265-1275784425763/SAREconomicUpdate7June2010.pdf>

between South and East Asia²⁰. Increasing cooperation and integration in the region would be a means for smaller South Asian economies to access East Asian markets through India. Therefore, over the years, strategic interests of the smaller South Asian economies are likely to become inextricably linked to successful integration with the Indian economy. Therefore in order to benefit from accessing greater markets of regions like East Asia, South Asian countries will be required to adopt more open policies towards each other.

2.4 *Tackling the financial crisis*

South Asia has had encouraging recovery from the financial crisis. However as is evident from the recent slag in the growth rate in India, the challenge will be to sustain the recovery and continue the growth. There is also a need to realign investment and trade priorities. In the post crisis era North America and Europe will spend less and grow at a slower pace. South and East Asia are drivers of global growth and this is a reality which should encourage integration strategies. There is potential of increasing trade in South Asia by USD 50 billion by increasing integration in the region²¹.

2.5 *Poverty Reduction*

South Asia is home to 40% of the world's poor, with 29.5% of its population living on less than \$1 a day. While almost a quarter of the world's population lives in the region, South Asia accounts for only 3% of global gross domestic product (GDP), 1.9% of world exports, and 1.7% of world foreign direct investment (FDI)²². Poverty remains a huge challenge for all South Asian countries. As discussed above, other than increasing regional trade by \$50 billion, regional integration will contribute towards creating opportunities in these countries. Open economies, adoption of stable macroeconomic policies will lead to an improved investment climate and thus increase the growth. Regional cooperation will lead to removal of barriers to trade, stimulate competition and help boost productive efficiency by better allocation and restructuring of industries. Increased growth rate would reduce poverty and improve standard of living. In this regard the manufacturing sector has tremendous potential to further employment generation. Increased integration will lead to access to technology, infrastructure, scales and improvement in infrastructure, all of which are currently impediments to the growth of the sector. A dynamic manufacturing sector with greater capacity will create huge opportunities and pull out many South Asians from poverty.

2.6 *Increased bargaining power*

With globalization, increasing insignificance of national boundaries and consequent increase in global governance regimes evolving through multilateral negotiations, smaller states recognize that regional cooperation and integration will give them a greater voice than isolated negotiations. Further, with the evolution and growth of the NAFTA and EU trading

²⁰ Rana P.B, Wignaraja G., Francois J.P, *Pan Asian Integration: Linking East and South Asia*, ADB and Palgrave McMillan, Manila (2009)

²¹ World Bank South Asia Economic Update 2010, Moving Up, Looking East, Available at <http://siteresources.worldbank.org/SOUTHASIAEXT/Resources/223546-1269620455636/6907265-1275784425763/SAREconomicUpdate7June2010.pdf>

²² Development Partnership Program for South Asia, *Study on Intraregional Trade and Investment in South Asia*, Asian Development Bank, (2009)

blocs, developing countries are also concerned about increasing protectionist sentiments. Cooperation and integration in regions is therefore an effective mechanism to gain the benefits of collective bargaining power in international negotiations and ensuring a place in regional markets.

2.7 Deliberate common issues and create regional infrastructure

South Asian nations, entwined in a mix of bilateral and regional issues have an opportunity through regional integration to work together to manage its numerous common regional issues. For instance, Mercosur had explicitly created a platform for its members to discuss common issues such as drug trafficking. In the context of South Asia, terrorism, environment, climate change, food security, intra region migration, infrastructure and regional security are some issues which require cooperative deliberation.

A related benefit is cooperation among the SAARC member countries to effectively utilize the rich river network in the region. The river network in the region comprising Ganga, Brahmaputra, Meghna and Indus rivers has the potential to meet a portion of the energy needs of the region and also create economic opportunities. Proper cooperative management of the water resources would contribute towards controlling floods, providing irrigation, generating electricity and improving water transport facilities. Previous treaties like the Indus River Treaty in 1960 between India and Pakistan and Farakka Treaty in 1996 between India and Bangladesh have been entered into to devise methods of sharing water resources. However, a sound cooperative model is yet to be achieved. In this context, effective management of water resources is a significant incentive to increase efforts to cooperate in the region. Another incentive is the urgency for energy security in the region. Nepal and Bhutan can be big sources of hydropower for the other countries. With Afghanistan as a new member, the region can also explore ways of engaging with central Asia to meet its energy needs.

The South Asian states have been contemplating a regional air services agreement, motor vehicle agreement and railway agreement for the past few years.

2.8 Peace Dividend

A serious commitment to integration, even if encouraged by economic incentives, is more likely to create a forum for peaceful resolutions of disputes than any of the isolated efforts have so far. In the context of India and Pakistan, SAARC Summits have been the most critical forums to deliberate bilateral issues and achieve the limited progress so far. The 1986 SAARC Summit also helped improve the relationship between India and Sri Lanka. This is in fact the reason why member states have always protected the SAARC institution, despite its overall ineffectiveness²³.

3. Changing dynamics

The region is fast changing and so are the economic and political realities around it. Economic factors are increasingly determining political relationships. The EU, ASEAN and other trading blocs are examples of how conflicts and national boundaries are being dispelled

²³ Desai V.V., *The Political Economy of Regional Integration*, Asian Development Bank, (July 2010)

in favor of increased economic benefits and opportunities. Further with the decline of hegemonic powers like the US in the realm of global affairs, countries are likely to rely more on regional/bilateral solutions to collective problems. South Asian nations are also realizing the importance of promoting regional cooperation in South Asia and the need to give primacy to economic development, growth, poverty reduction and push political issues and problems to the background. It realizes that holding on to historic differences could cost it a place in the global economy given the increased competition, the current world economic environment and protectionist tendencies of other regions. The region's importance is gradually being recognized by the rest of the world. The global recognition of SAARC is evidenced by the fact that China, Japan, South Korea, EU and USA have shown keen participatory interest. These countries have been appointed observers at the SAARC summits. Presence of other nations is seen as a balancing factor by the South Asian countries. Their presence at SAARC meetings subjects South Asian countries to outside scrutiny and is also likely to enhance the process of integration between South and East Asia. Such changing dynamics within the region and outside have created specific incentives for each SAARC member state in addition to the common incentives discussed above.

Over the past few years, India has made significant efforts towards improving relations with its neighbors. Conveying India's commitment to South Asian integration at the SAARC summit 2011 in Maldives, the prime minister announced reduction of items from SAFTA's Sensitive List for least developed countries from 480 to 25. It has also reduced peak tariff rate to 8% for Non-Least Developed Countries under SAFTA²⁴. As India continues on a good growth trajectory and moves ahead to secure a more global position, it can no longer ignore the relevance of regional cooperation. With integration and cooperation in the region, India is likely to gain credibility in international forums. It will be seen as an anchor in a stable region and as a well regarded representative of the region. This would enable India to assume a greater role in international forums. This is particularly relevant given India's ambition of securing a seat in the UN Security Council. India has also been observing China's growing strategic interests in South Asia. Aside from being a generous aid-giver, China is involved in infrastructure projects in the region, including building ports in Bangladesh, Sri Lanka (*Hambanthotta*) and Pakistan. It has recently opened an embassy in Maldives, built the foreign ministry, national museum buildings and is currently working on the largest housing project in Maldives. China's observer status was a product of the push from Nepal, Bangladesh and Pakistan. China also recently asked for a SAARC plus one meeting on the lines of ASEAN plus one and thus is clearly looking for gaining a bigger voice in the region. In this context, it is most critical and strategically relevant for India to improve relations with its neighbors and encourage integration.

A recent development has been Pakistan's commitment to grant India the MFN status²⁵ by the end of this year and to reduce items on the negative list²⁶. Apart from being in constant state of turmoil due to political instability, Pakistan is at crossroads in terms of its foreign policy options. There has been a clear shift in the United States' policy towards India, marked by increasing support to India and a decline in support to Pakistan. Pakistan has over

²⁴ Notification no. 125/2011-Customs dated 30.12.2011.

²⁵ India granted Pakistan the MFN status in 1996.

²⁶ *South Asia to gain when Pakistan frees trade with India: Chamber Head*, Economic Times, March 21, 2012, Available at http://articles.economictimes.indiatimes.com/2012-03-21/news/31220180_1_negative-list-pakistan-grants-grants-india-mfn-status

the past years tried to establish a relationship with the Gulf states, China and Central Asia. However, improving relations between India and China, support of states like Iran to India on the Kashmir issue and instability in Central Asia are some reasons why increased cooperation with India and integration in the region are almost inevitable for Pakistan. It is also critical for Pakistan to seek India's cooperation in countering its own challenges such as ethnic conflicts, drug trafficking and terrorism.

Like the rest of South Asia, Pakistan also needs new markets for its exports. Due to the recent economic crisis, protectionist tendencies of the developed markets like Japan, North America and Western Europe have increased. Consequently, Pakistan along with Iran and Turkey formed the Economic Cooperation Organization (ECO) to boost its exports and improve intra-regional trade with the Central Asian countries. However given the current economic environment, the competition is tough to gain access to these markets as well. The demand of products from Gulf countries has also reduced. Pakistan thus would benefit greatly by accessing the large South Asian market.

Improving relations with India would also help Pakistan lower its expenditure on defense and reallocate its limited resources to economically beneficial sectors and development. Further, to encourage foreign direct investment in the country and effectively compete with other countries within and outside South Asia, it is critical to create a safe environment internally and in the region. Such considerations should motivate Pakistan to accelerate cooperation and integration in South Asia.

Studies suggest that Pakistan could accelerate its rate of growth to 8.0 per cent by 2025 if it can settle its relations with India. Peace and strong economic ties with India could add almost US\$200 billion to Pakistan's gross domestic product, increasing it from US\$375 billion in 2007 to US\$571 billion a year. This translates into an increase of US\$850 in per capita income by 2025.²⁷

Bangladesh's core interests in increasing cooperation in the region are increasing investments, cooperative use of water resources, access to raw materials and development of infrastructure. India needs Bangladesh's cooperation to further its security interests, use of Chittagong Port, improve transit to north east India and for countering terrorism. The government of Bangladesh since January 2009, has been bridging the gap between India and Bangladesh. War crime trials were initiated against those who collaborated with the Pakistan Army in its atrocities during the 1971 war. The 5th Amendment of the constitution, which gave legitimacy to military dictatorships and removed secularism from state policy has been repealed. Article 12 of the constitution proscribing religious parties has also been deleted. These developments have brought Bangladesh closer to democratic and secular governance. All these developments have created an environment conducive for participation of Bangladesh in regional economic integration initiatives.

Nepal has cordial relations with all its neighbors. As a least developed country in the region, Nepal is in serious need of economic development. Its other interests are ensuring security,

²⁷ Burki, Shahid Javed, *South Asia's Economic Future With or Without Economic Integration*, ISAS (Institute of South Asian Studies) Working Paper No.110, National University of Singapore, (July 14, 2010). Increased trade with Pakistan could increase India's GDP by US\$1.5 trillion and its per capita GDP by US\$1,140.

diversifying its trade and bilateral relations in the region to avoid absolute reliance on India for resources and development²⁸. Nepal is also a landlocked country with an insignificant industrial sector and a narrow export base. Assistance from donor agencies like the World Bank has been reducing and Nepal generates very limited business. As a result of these factors, Nepal has very material incentives to promote cooperation and integration in South Asia.

Sri Lanka has generally supported regional integration in South Asia. Like Nepal, Sri Lanka also has only India as a neighbor. Dwindling demands from rest of the world and decline in FDI due to its continued civil war have encouraged Sri Lanka to look to its neighbors.

Bhutan views regional economic cooperation as a strategy to bring about economic self-reliance and mutual prosperity. As a landlocked country, Bhutan aims to improve air links and telecommunication between the member states, facilitate trade, joint economic ventures, achieve greater liberalization in its economy and increase security in the region. Therefore Bhutan has had an open and forthcoming approach towards SAARC. Bhutan has entered into various bilateral agreements in the region²⁹. Bhutan has continued to maintain good relations with India³⁰.

III. Lessons from other regional integration arrangements

ASEAN, founded in 1967, already trades 25 per cent within itself and has expressly declared its intent to become a regional trading bloc like the EU³¹. Its founding members, Indonesia, Malaysia, Philippines, Singapore and Thailand were joined by Brunei Darussalam in 1984. The ASEAN Free Trade Area (AFTA) was formed in 1993, and subsequently four new members joined (i.e. Vietnam in 1995, Laos and Myanmar in 1997, and Cambodia in 1999). Inspired by EU and NAFTA, ASEAN nations also wanted to gain the benefits of regional integration. The Asian financial crisis of 1997-1998, limited help from the US, brought about a solidarity among the ASEAN member nations and motivated them to enhance economic relations and institutional cooperation. At the time of the crisis there was also an impression that Japan wanted to increase its influence in the region by establishing the Asian Monetary

²⁸ In March 1989, due to differences on trade and transit issues, there was a deadlock between Nepal and India. Nepal's extreme reliance on India and lack of autonomy became very apparent. There was shortage of essential commodities, collapse of the tourism industry, dwindling forest and natural resources.

²⁹ With Bangladesh, Bhutan has signed a trade agreement, an agreement on air services and economic and technical cooperation. With India, Bhutan has entered a series of four agreements in 2009 covering energy, educational, and vocational needs. 10 hydropower projects are being proposed between the countries of which 6 will be financed through an intergovernmental model, in which India will supply 40% of the cost as grants and the remaining 60% as loans. Similarly, cooperation efforts have been made with the other countries as well. See *Economic and Political Relations between Bhutan and Neighbouring Countries*, A Joint Research Project of the Center for Bhutan Studies and the Institute of Developing Economies, Japan External Trade Organization, Available at http://archiv.ub.uni-heidelberg.de/savifadok/volltexte/2009/303/pdf/mono_Ecnmc_Pol_Rel_Bt_Nghbrng.pdf, (2004).

³⁰ With a renewed free trade agreement with India until 2015, there has been a rise in exports to India.

³¹ As the ASEAN Declaration stated, ASEAN was established for regional cooperation with two fundamental objectives: (1) to accelerate economic growth, social progress, and cultural development in the region; and (2) to reduce historical conflicts and foster regional peace and stability without interventions in domestic affairs.

Fund, which was opposed by the IMF and US³². The emergence of Brazil, Russia, India and China as economic powers with increasing portions in world trade also made ASEAN nations aware of the need to increase their competitiveness in the global economy. Further, the continued deadlock of the Doha Development Agenda also encouraged ASEAN nations to create alternate trade related institutional frameworks.

The ASEAN and other regional institutions like the EU are distinguished from the SAARC in some significant ways.

i. Effective Leadership and acceptance of Leadership

The most critical challenge to integration in South Asia is the huge trust deficit. As the largest and most powerful state in the region, India has been unable to engender enough confidence among member states in its commitment to non-interference, to resolve bilateral disputes and to provide large hearted leadership. Disharmony, insecurity, lack of consensus and faith on India's primacy and leadership role in the region has resulted in lack of committed leadership and direction. In regions where there are power imbalances, smaller states may tacitly recognize the pre-eminent position of the powerful state in exchange for the powerful state's commitment to non-interference and peaceful resolution of disputes. In return, smaller states get leadership and a collective bargaining power. This role was assumed by West Germany in the EU and Indonesia in ASEAN. It is critical for India to take on a leadership role and be more open in its dialogue with neighboring states. Since regional cooperation actually leads to some erosion of policy autonomy, governments and stakeholders tend to adopt a lackadaisical approach and make unhurried reluctant efforts. To make regional integration work, member states, specifically the leading state, need to be sufficiently motivated.

Inadequate leadership has been found to be a key reason for failure of previous integration agreements in other regions. For instance it has been argued that that several regional cooperation agreements including the Latin American Free Trade Area, the Andean Pact, Caribbean Community, Arab Common Market and the Economic Community of West African States were affected by the absence of leadership. Lack of adequate leadership has also resulted in insufficient financial commitment by India towards SAARC.

Other South Asian states also need to change their approach towards integration. Cooperation and integration will require aligning their economic interests with the developments in the Indian economy and increased interdependence with India is inevitable. It must be realized that an approach of accommodation would be more productive than that of isolation, suspicion and mistrust. There is an urgent need to focus on inward looking policies for setting up infrastructure to facilitate foreign investments in the states and thereby reducing the trade deficits in the region. In this regard, the relationship between India and Sri Lanka has been notable. The FTA between the countries encouraged FDI and contributed to reduction of trade balance of Sri Lanka with India.

Smaller countries can play an important role in identifying new initiatives since it's often easier to obtain consensus on initiatives of smaller countries. Belgium and Luxembourg in

³² See Plummer, Michael G., *Towards Win-Win Regionalism in Asia: Issues and Challenges in forming Efficient Trade Agreements*, Asian Development Bank Working Paper, (October 2006)

the EU and Singapore in ASEAN played such a role and took key initiatives³³. Acceptance of leadership and active contribution by the smaller states is as critical as appropriate leadership in the region.

ii. Primacy of economic interests

Experience suggests that economic interests/threats have most significantly influenced and motivated regional integration. For instance in the case of ASEAN, it was the threat of spreading communism and of an overpowering China. In the context of South Asia, economic interests can unite all the countries. An economic centric approach would be useful in the short run to gain consensus, break the ice and make the initial move and begin bridging the huge trust deficit. In this process, India will be required to adopt an accommodating approach and in certain circumstances part with requirements of reciprocity and other technicalities in trade negotiations. Ofcourse, it is unrealistic to believe that substantial and sustainable regional integration in South Asia is possible without easing the deep rooted political tensions. A gradual progression in the process to eventually create an understanding on security and other bilateral issues seems more plausible rather than waiting to “solve” political issues before commencing economic integration. It would be useful for the SAARC to institutionalize an “economic agenda”. Once economic benefits are reaped by the South Asian states it is likely that the commitment of the countries to furthering integration and understanding would automatically increase.

iii. Rising above political differences

Mutual suspicion over other member states’ ambitions and political differences are common in almost all regional relations and are not unique to South Asia. In both ASEAN and EU, long standing political differences were kept aside while efforts towards regional integration were made. Eventually this led to greater peace and stability in the region. Increased integration provides formal and informal channels of communication and gradual building of trust among the countries. During the time of formation of the ASEAN, every Southeast Asian nation³⁴ was fighting some form of insurgency and ethnic tensions which also had spill-over effects to embitter interstate relationships. However, the threat of instability in the region and the external threat of China brought the states together to create a unified regional entity and resolve disputes through peaceful dialogue and consultations. Further, ASEAN nations also recognized the need of Indonesia to maintain high levels of military resources and felt it was in their best interest to cooperate with Indonesia and focus on developing trust within the region. Stepping beyond historic differences to achieve the end objective of stability, depicted by the Southeast Asian nations³⁵ needs to be replicated in South Asia.

iv. Public Opinion

³³ See Sawhney, Aparna, Kumar, Rajiv, *Why SAFTA*, Commonwealth Secretariat, CUTS International. Available at <http://genderandtrade.org/files/178432/FileName/WhySAFTA-Final.doc2.pdf>.

³⁴ For instance, Malaysia and Singapore had just had a difficult separation; Malaysia and Philippines had competing claims on Sabah in Borneo; Indonesia was in the middle of disputes with Malaysia (Konfrontasi).

³⁵ Other integration arrangements have also been formed to reduce inter-state tensions. For instance Mercosur to reduce tensions between Argentina and Brazil; Egypt, Morocco and Tunisia signed an agreement with EU to contain the threat of spreading fundamentalism.

Economic integration which affects a nation's domestic arrangements (i.e. trade in goods, services, security) and is mired in political/security controversies is also impacted in subtle ways by public opinion and perceptions held by its people. Geographical proximity, travel, historical experiences have caused public perceptions on the issue of regional integration in South Asia. As discussed in the study by Dash, there is a grossly negative perception of the relationship, tending towards hostility, between the South Asian countries. Such public opinion constitutes the basis of the approach of other stake holders like business/industry members, lobbyists, bureaucracy and consequently leads to an unconvincing/reluctant approach towards increasing integration. The lack of support from civil society results in insufficient and ineffective demand for cooperation from the states' government. In this context, it becomes particularly important to improve public perception through soft diplomacy and increased interaction emphasizing the common cultures, languages, history and interests of the people of the member states³⁶. This will also bridge the information deficit among the South Asian Nations. Both business and academia can be critical contributors. ASEAN also focused on softer and less controversial issues at the beginning. For instance like the ASEAN Pass and ASEAN hip hop, there can be an attempt to build relationships through South Asia tourism circuits, cricket and air connectivity.

v. Political Will

South Asian integration efforts have been mild and characterized by lack of political will. By contrast, the signing of the Treaty of Rome in 1957, establishing the EU, was preceded by strong sentiments for solidarity in the region. There was strong political will to unite and create a prosperous and peaceful bloc of European nations. Leaders realized that it was essential to look beyond their political differences, and promote cooperation in key economic sectors (specially in key sectors like coal and steel in warring nations of France and Germany) for unified Europe. With respect to SAARC, an analysis of the country objectives at the time of its formation suggests that member states had their own respective agendas and regional cooperation was not the primary motive for joining the association. Merely placing an institutional structure in place is not enough. It is imperative that the political leadership in the member states shares a common vision of an integrated regional bloc.

The strong political will depicted by the EU was in fact able to unite the nations even to agree that a precondition to the membership of EU was similarity of political systems (i.e. democratic governance). South Asia is characterized by wildly divergent political systems - India and Sri Lanka are reasonably functioning democracies, Pakistan and Bangladesh still need to establish themselves as functioning democracies dissociated from military dominance, Nepal continues to fight threats of Maoists, Bhutan is a monarchy while Afghanistan and Maldives also have struggling political systems. Experience shows that economic integration is more plausible and sustained when it is preceded by political harmonization³⁷. EU set the rule of making only democracies eligible for membership. Consequently, Spain, Portugal and Greece discarded their dictatorships and thereafter became

³⁶ In this regard Prime Minister Singh announced increased educational and cultural exchanges at the SAARC Summit in 2011. Prime Minister Manmohan Singh speaks at the SAARC Summit, available at <http://www.ndtv.com/article/india/prime-minister-manmohan-singh-speaks-at-the-saarc-summit-full-text-148625>. An initiative has also been made towards setting up a South Asian University.

³⁷ Bhatta Chandra D, *Regional Integration and peace in South Asia: An Analysis*, London School of Economics and Political Science.

members. Such preconditions can be set only when there is strong political will of all states. In the longer run, such preconditions would be beneficial since without political harmonization it is difficult to expect countries to surrender their sovereignty (in favor of the regional association) on issues such as import policy or grant other economic concessions. However, while the EU tried to facilitate common values and political security goals, ASEAN operated on the principle of non-interference in domestic matters focusing primarily on economic interests.

vi. Institutional Support

South Asian integration process needs to be supported by an effective institutional set up. This will facilitate the process by closer interactions between regional centers, implementing entities. On account of the absence of political will of the countries, the current SAARC secretariat lacks sufficient funds and expertise to provide the type of support required.

vii. Multilateral Approach

In the ASEAN region, the integration has been achieved by a multi-pronged process and by following a multilateral approach. A multilateral approach encourages a shift towards stronger cooperation and increases focus on regional objectives. Multilateral agreements take the existing bilateral/domestic issues to a regional level and bind signatory countries to a timetable for implementation at a regional level. The ASEAN nations signed a series of multilateral agreements in the areas of trade, services and investment. The four main components were the Agreement on the Common Effective Preferential Tariff Scheme for the ASEAN Free Trade Area (CEPT-AFTA) signed in 1992, the ASEAN Framework on Services (AFAS) signed in 1995, the Basic Agreement on the ASEAN Industrial Cooperation Scheme signed in 1996 and the Framework Agreement on the ASEAN Investment Area (AIA) which was signed in 1998. These legal instruments were supported by other cooperative efforts such as harmonizing other regulations and building ASEAN infrastructure.

Aspects of the ASEAN trade and investment agreements have been discussed later in this paper. In the area of services, the AFAS is intended to enhance cooperation in services, improve efficiency and competitiveness, diversify production capacity, improve supply and distribution of services. The AFAS encouraged members to undertake obligations beyond the General Agreement on Trade in Services. So far the focus areas have been financial services, transport, telecommunications, tourism, and professional business services. In July 2003, the ASEAN nations identified 11 priority sectors for which liberalisation was to be accelerated and completed by 2010. These sectors include air travel, e-ASEAN (internet governance), healthcare and tourism. A 12th priority sector, logistics services, was identified in 2006. Efforts have been made to integrate these sectors over the past few years through Mutual Recognition Arrangements (MRA). Under these arrangements contracting countries mutually recognize the authorizations and licenses issued to professional service providers. Services such as engineering, nursing, architecture, accountancy, medical and dental have been

covered under these arrangements in the ASEAN region³⁸. Currently all of these MRAs are in different stages of implementation.

ASEAN nations have signed other multilateral agreements covering issues such as migrant workers³⁹, air freight services, inter state transport⁴⁰. They have also found multilateral solutions to some of their regional issues⁴¹. The region has also firmed multilateral initiatives in the specialized areas of intellectual property and competition through the IPR Action Plan and the ASEAN Experts Group. The ASEAN has been at the center of all of these initiatives and facilitated a shift from the bilateral to a multilateral approach. To encourage greater integration in South Asia similar levels of institutional support and initiative of the SAARC will be required.

IV. Trade and Investment Agreements

Inspired by similar developments around the world, the Agreement on South Asian Free Trade Area (SAFTA) was signed on January 6, 2004 and was motivated by the “*commitment to strengthen intra-SAARC economic cooperation to maximize the realization of the region’s potential for trade and development for the benefit of their (member states’) people...*”. Till date, SAFTA has remained an ineffective legislation with little movement towards its objective. The primary reason for this are the political economic impediments discussed above. SAFTA entered into force on January 1, 2006⁴².

As is the case in any legal agreement, investment and trade agreements only capture the relationship between the contracting states. Agreements differ from one another depending on the understanding between the parties, pursuit of non-economic objectives such as regional stability, balance of power among contracting states, political structures and processes. A bilateral agreement only operates within the limitation of mutual relationships and political and economic realities affecting the contracting states⁴³. Therefore absent the motivation and will, technical aspects of agreements per se have limited contribution to the success of regional integration.

³⁸ *ASEAN Integration on trade in Services: Development, Challenges and the way Forward* (Draft Paper), ADBI-PECC Conference (June 2011), Available at http://www.pecc.org/resources/doc_view/1715-asean-integration-in-trade-in-services-development-challenges-and-way-forward-paper

³⁹ See ASEAN Declaration on the Protection and Promotion of the Rights of Migrant Workers, 2007.

⁴⁰ The objective of this agreement is to deepen and broaden ASEAN’s internal economic integration and linkages with the world economy through transport cooperation and initiatives. The Multilateral Agreements on Full Liberalization of Air Freight Services and Air Services aim to liberalize passenger and cargo services in the region with the objective of achieving flexibility and capacity in the operation of air freight services and air services in ASEAN and building a unified aviation market by 2015.

⁴¹ For instance, the Chiang Mai Initiative was a response to the 1997 Asian Crisis and was constituted as a regional self-help mechanism where internal regional resources have been raised to address future financial crises.

⁴² SAFTA (as per Article 22) superseded the SAARC Preferential Trading Arrangement dated April 11, 1993.

⁴³ Regional agreements such as the Greater Mekong Sub-Regional arrangements have been successful in bringing together once adversarial countries in development of joint infrastructural facilities and further integration of smaller East Asian economies into the ASEAN. On the other hand the Asia-Pacific Trade Agreement, Bay of Bengal Initiative for multi-sectoral technical and regional cooperation have had limited achievements. The performance of these integration agreements and arrangements vary because varying forces and factors influence these agreements.

However, by binding countries to their commitments and putting in place a framework to govern relations between countries, agreements contribute towards creating a fit environment for integration. It is therefore useful to analyse trade and investment agreements and assess their inadequacies. The following is a review of certain technical aspects of the SAFTA which should be addressed to facilitate the integration process in South Asia.

a) impact of bilateral preferential trade agreements

The enabling clause of the WTO⁴⁴ permits differential and more favorable treatment of developing countries and is the legal basis for various preferential trade agreements/bilateral investment treaties entered into by developing country WTO members. In the past few years many bilateral treaties have been entered into in South Asia. Many of these treaties provide more advanced liberalization schemes than SAFTA and consequently have become a preferred mechanism to trade under. Due to this, the incentive to support broader regional integration through SAFTA is reduced. Arguably, stakeholders in member countries could even lobby against liberalization under SAFTA since that would imply greater competition from the region to enter/stay in the market it already has access to through an existing bilateral agreement.

Compared to SAFTA, bilateral agreements in the region provide better market access, liberal rules of origin, faster tariff reduction schedules, restricted non tariff barriers⁴⁵. For instance less than 14% of Sri Lanka's exports are covered by the Indian sensitive list under the India-Sri Lanka bilateral agreement, but nearly 42% of Sri Lanka's exports are covered in the Indian sensitive list under the SAFTA Agreement⁴⁶. Also, the Pakistan-Sri Lanka bilateral agreement⁴⁷, Pakistan's sensitive list consists of 540 items which is much lesser than 1169 items provided under the SAFTA. In the same agreement, Sri Lanka sensitive list comprises 697 items which is again lesser than the 1065 provided under SAFTA⁴⁸. This particularly impacts the least developed contracting parties (LDC) of the SAFTA. In the Pakistan-Sri Lanka bilateral agreement, both countries grant better market access to each other than they do to LDCs in SAFTA⁴⁹. Similarly, in the India- Sri Lanka

⁴⁴ See WTO Decision, Differential and More Favorable Treatment Reciprocity and Fuller Participation of Developing Countries, Decision of 28 November 1979 (L/4903), Available at http://www.wto.org/english/docs_e/legal_e/enabling1979_e.htm

⁴⁵ See Islam, Rizwanul Md. *Constraints of the Agreement on South Asian Free Trade Area and SAARC Agreement on Trade in Services Militating against the Sub Regional Trade Proliferation in South Asia*, Macquarie University, (2010)

⁴⁶ Dubey, M., *SAARC and South Asian Economic Integration*, Economic and Political. Weekly. (April 2007). Dubey, M., *Regional Economic Integration in South Asia: Principal Issues and the Role of Political Factors*. Paper presented at the Conference on "Does South Asia Exist? Prospects for Regionalism in South Asia". Stanford University. Cited in Kumar Rajeev, Singh Manjeeta, India's Role and South Asia Trade and Investment Integration, Asian Development Bank Working Paper No. 32, (July 2009)

⁴⁷ Pakistan Sri Lanka Free Trade Agreement, August. 1, 2002, Sri Lanka Department of Commerce, Available at http://www.doc.gov.lk/web/pakissrilanka_freetrade.php.

⁴⁸ See Islam, Rizwanul Md, *Constraints of the Agreement on South Asian Free Trade Area and SAARC Agreement on Trade in Services Militating against the Sub Regional Trade Proliferation in South Asia*, Macquarie University, (2010)

⁴⁹ Designation as least developed country entitles the country to receive certain special and favorable treatment with respect to restrictions. Under SAFTA, Nepal, Bangladesh, Bhutan and Maldives have been

agreement, India offers better market access to Sri Lanka than it does to LDCs under SAFTA. Thus LDCs are effectively denied the special and preferential treatment that they are entitled to on a non-reciprocal basis under Article 3 of the SAFTA. Notably, Article 13 provides that provisions of SAFTA do not apply to any preference given to third party states or contracting parties outside the SAFTA framework. Thus while there is no violation of a provision of SAFTA, difference in preferential treatment to some LDCs due to bilateral agreements can cause LDC's to lose an advantage under SAFTA.

Under SAFTA, tariffs are required to be reduced to between 0-5% by 2016⁵⁰. Both Pakistan-Sri Lanka and India-Sri Lanka bilateral agreements have more accelerated tariff reduction schedules⁵¹. Other agreements also grant discriminatory benefits. For instance under the India-Maldives agreement⁵², Maldives is allowed to import products like river sand, eggs, potatoes and onions which are otherwise subject to export bans in India. Since all countries other than India are net food importing countries in South Asia, Maldives greatly benefits from the regular and steady supply of essentials from India.

Some bilateral agreements also provide more favorable rules of origin than SAFTA. For instance under the India-Sri Lanka bilateral agreement, even a product not wholly produced in one of the contracting states is eligible for preferential treatment provided inputs from third parties do not exceed sixty-five percent of the final product and the processing takes place in the contracting party's territory⁵³. Further, the final product line should be different from the inputs taken from the third parties. In case of developing member states (not LDCs) SAFTA allows sixty percent third party inputs. Thus producers using between sixty to sixty five percent inputs from third parties, would have to rely on the India-Sri Lanka bilateral agreement over SAFTA.

To some extent, such preferential treatment in bilateral agreements undermines the relevance of SAFTA. While such agreements improve bilateral relations between states, it is questionable whether they contribute to the long term objective of economic integration in the region.

As discussed earlier, ASEAN region has adopted a multilateral CEPT-AFTA. As of 2007 98.58% of the total products in ASEAN have been brought into the CEPT Inclusion list, and tariffs of 93.67% of these products had been reduced to within 0-5%. Tariffs on 98.67% of the products in the inclusion list of the ASEAN-6 had been brought down to the 0-5% range⁵⁴. Efforts have been made towards establishment of a regional production network, transportation and communication networks which have contributed towards

designated least developed countries (the determination is made based on factors such as health, literacy rates, growth and other development indicators).

⁵⁰ Article 7(1)(d) SAFTA

⁵¹ Under the India-Sri Lanka Free Trade Agreement, India is expected to eliminate tariffs by 2003 and Sri Lanka by 2008. India already completed its tariff liberalization program on March 18, 2003, thereby granting duty free status on 81% of all items.

⁵² Trade Agreement between Government of Republic of India and Government of Republic of Maldives, Article VIII-IX, March 31, 1981 Available at <http://commerce.nic.in/trade/maldives.pdf>

⁵³ India-Sri Lanka Free Trade Agreement – Article 7 (a) Rules of Origins Requirements, Annex C.

⁵⁴ See www.aseansec.org (2007)

reduction of trade and transportation costs⁵⁵. Member states have also established the ASEAN Trade Facilitation Work Program. The ASEAN Single Window is a tremendous effort which enables exchange of standardized data among countries' customs agencies, though the success of the initiative still remains to be seen.

b) wide sensitive lists

Due to inherent protectionist attitudes, the sensitive lists in SAFTA are very wide. This has significant consequences for LDCs, which have limited export capacities⁵⁶ and find most of their exportable items on sensitive lists of other member countries. As a result they gain very limited market access benefits. Notably, it has been the case that such lists have not always restricted exports but have in fact led to business being transacted via illegal channels. A gradual reduction of items on these lists could raise revenue channels of the government and curb the illegal movement of goods across borders.

c) limited restrictions on trade remedy measures

The SAFTA has limited provisions restricting trade remedy measures such as anti-dumping and countervailing duties. Given the current global financial conditions⁵⁷ and with growing trade, increasing volumes in the region, such measures can be increasingly used as protectionist devices.

d) insufficient coverage of non-tariff barriers

Non tariff barriers such as licensing requirements, quality control provisions, rules of valuation, rules of origin, inspection requirements are increasingly becoming the favored means of protectionism. SAFTA has insufficient provisions to address this critical area. Article 7(4) of SAFTA requires contracting states to notify the Committee on Expert (COE) about their non-tariff barriers. After examining the non-tariff barriers and checking for conformity with the WTO rules, the COE will recommend elimination or implementation of the measures in the least trade restrictive manner. Article 10 which provides for setting up of the COE and its functioning does not provide any guidance on how the recommendations of the COE are to be implemented.

e) dispute settlement mechanism

Institutional mechanisms such as dispute settlement systems are a critical component of formal trading systems. A comprehensive and complete dispute settlement mechanism reduces uncertainties of government and regulatory policies and procedures and increases reliability of the trading system. Article 10 of the SAFTA provides a dispute resolution

⁵⁵ For instance major inter-state highway and railway networks were built to improve the infrastructure among the members. Some examples are the Singapore to Kunming Rail-Link, principal ports and sea lanes for maritime traffic and major civil aviation links.

⁵⁶ For instance, Afghanistan's export items include carpets, fresh and dried fruits, cotton, wool and vegetables. (See <http://www.afghanchamber.com/>). Bhutan's main exports are textiles, stones, cement and asbestos products.

⁵⁷ The WTO Secretariat noted that member states initiated 17% more anti-dumping investigations during July-December 2008 than previous years. "WTO Secretariat reports increase in new antidumping investigations", (May 7, 2009).

framework. Article 20 of SAFTA provides the framework for the dispute settlement mechanism. The SAARC Ministerial Council (SMC) comprising ministers of commerce/trade of the contracting states is the highest administrative/appellate body and the committee of experts is the primary dispute settlement body. Article 20 lays down provisions on consultations, timely review by COE and procedures for seeking appellate review by SMC.

Dispute settlement mechanisms can either follow a negotiation based approach or a rules based approach. Since the rules based approach provides a more impartial, consistent and unbiased platform for resolving disputes it is a more preferred approach. While the ASEAN⁵⁸ follows a rules based approach in its dispute settlement mechanism, SAFTA still requires more clarity and depth to move towards a rules based approach⁵⁹. One issue is that SAFTA does not identify and demarcate the scope and jurisdiction of the dispute settlement mechanism. It is unclear whether contracting states can concurrently approach the WTO to resolve trade related disputes. The ASEAN Protocol provides jurisdictional flexibility by allowing contracting states to use any other dispute settlement mechanism before initiating the formal measures under the ASEAN Protocol. It allows contracting states to use any other forums before resorting to the ASEAN mechanism. Such flexibility would be perceived by smaller states like Maldives and Nepal as an option to take disputes to forums not affected by the unfair power dynamics in the region.

A situation not covered in SAFTA is where the actions or laws of a contracting state may negate the purpose/essence of SAFTA without actually violating a specific provision (i.e. non violation claims). While including such a provision would undermine the legislative/administrative freedom of a contracting state, it would also contribute towards strengthening the pact between the South Asian nations to adhere to the principles of SAFTA and regional integration. The ASEAN Protocol has incorporated such a provision requiring good faith efforts by contracting states towards the objectives of ASEAN. The ASEAN Protocol allows contracting states to make representations/proposals to violating states to remedy the detrimental actions.

A second issue is that SAFTA does not provide any selection criterion or guidelines for selection of members of COE other than that the members hold “Senior Economic Official” positions and have expertise in trade matters. There are no mandatory minimums with respect to qualifications, age, years of expertise in trade law, economics and policy. The agreement also does not permit non governmental organizations or scholars, academicians or private practitioners from providing their expertise in a dispute⁶⁰. ASEAN Protocol provides detailed criterion for composition of panels and for appointment of non governmental personnel. It specifies a broad range of criterion such as publication, teaching, professional experiences in a variety of fields. This ensures certainty and diminishes fears of bias in the effective adjudication of disputes.

⁵⁸ Article 9 of the 1992 Framework Agreement establishing the AFTA provided for the dispute settlement mechanism. In 1996 the Protocol on Dispute Settlement Mechanism was adopted to implement the AFTA agreements. In 2004, this was superseded by the ASEAN Protocol on Enhanced Dispute Settlement Mechanism (Nov 29, 2004) (ASEAN Protocol).

⁵⁹ Albren Brett A, *The Continued Need for a Narrowly Tailored Rule Based Dispute Resolution Mechanism in Future Free Trade Agreements*, 20 Suffolk Transnational Law Review 85, 105-107 (1996)

⁶⁰ Assistance of specialists may be sought for peer review of matter referred to the COE. However, SAFTA is silent on the qualifications or selection procedure of the Specialists.

SAFTA provides that COE must conclude an investigation and make recommendations within 60 days of the dispute being instituted. It does not however provide any procedures, rules or other guidance with respect to how the investigation must be carried out particularly on presentation of evidence, access of information by the public, presentation of arguments and submissions. It allows the COE to use its own rules of procedure without providing any framework. While it is indeed beneficial to provide some extent of flexibility to the COE to determine their mechanism for operating, complete lack of guidance renders the mechanism very unpredictable. Again, taking the example of ASEAN, the ASEAN Protocol stipulates procedures by which parties can present their complaint, responses, third party allegations and evidence. Including an operating framework in SAFTA, would ensure fairness, lessen the ambiguity and evince trust and confidence of the contracting states to rely on SAFTA as a preferred trading forum. Allowing public access to COE recommendations would increase transparency and allow critique by stakeholders and thereby improve the general environment in the region.

The third gap is the lack of detail on the scope and process of the appellate review. The SMC which comprises ministers of commerce of the contracting states is particularly vulnerable to allegations of bias on account of political differences⁶¹. The ASEAN Protocol requires the ASEAN Economic Ministers to establish the appellate review panel, comprised of highly competent and experienced individuals. It also provides that panel members are prohibited from having specific government connections or any potential “direct or indirect conflict of interest”. The Protocol defines the scope of the review as only “issues of law covered in the panel report and legal interpretation developed by the panel”⁶². It also allows interested third parties to present their views to the appellate body.

An effective and reliable dispute settlement mechanism is so critical particularly in the context of South Asia where there is in any case an environment of suspicion and huge trust deficit. A clear and comprehensive dispute settlement mechanism would encourage otherwise reluctant states to accept their obligations under SAFTA.

On the investment side, countries in South Asia have entered into bilateral investment treaties (BIT) to boost investor confidence. There is currently no multilateral investment treaty in the region. A closer look at the BITs in South Asia and Southeast Asia indicates that BITs have a limited impact on increasing regional integration.

BITs are agreements between two signatories which provide legal standards of protection for foreign investors (i.e. supplementary legal protection to national laws). Historically, BITs were initiated and promoted by the capital-exporting countries. The objective was to establish an international legal framework to protect the investment of their nationals in foreign countries. There has been a shift in this trend and developing countries are signing numerous BITs with developed countries as a mechanism to enhance their investment climate. BITs vary across countries, but they generally share similar features of defining foreign investment and laying out various principles regarding treatment, transfer of funds, expropriation and

⁶¹ Article 10(3) and 20(9) SAFTA

⁶² Article 12(6) ASEAN Protocol

mechanisms for dispute settlements. The central objective of all BITs is the assurance it gives investors regarding their property rights.

This study examines BITs both from the perspective of network (i.e. number of countries having BITs with each other within South Asia and Southeast Asia) and content⁶³.

From the perspective of network, there are 4 BITs in South Asia as compared to 14 in the ASEAN region⁶⁴. The following tables details the coverage of BITs in both the regions.

Table 1. Existing BITs in South Asia

| | Afghanistan | Bangladesh | Bhutan | India | Maldives | Nepal | Pakistan | Sri Lanka |
|-------------|-------------|------------|---------|---------|----------|---------|----------|-----------|
| Afghanistan | | Missing | Missing | Missing | Missing | Missing | Missing | Missing |
| Bangladesh | Missing | | Missing | Exists | Missing | Missing | Missing | Missing |
| Bhutan | Missing | Missing | | Missing | Missing | Missing | Missing | Missing |
| India | Missing | Exists | Missing | | Missing | Exists | Missing | Exists |
| Maldives | Missing | Missing | Missing | Missing | | Missing | Missing | Missing |
| Nepal | Missing | Missing | Missing | Exists | Missing | | Missing | Missing |
| Pakistan | Missing | Missing | Missing | Missing | Missing | Missing | | Exists |
| Sri Lanka | Missing | Missing | Missing | Exists | Missing | Missing | Exists | |

Source: UNCTAD Database, May 2012; Ministry of Commerce, India

Table 2. Existing BITs in South East Asia

| | Cambodia | Indonesia | Lao | Malaysia | Philippines | Singapore | Thailand | Vietnam |
|-------------|----------|-----------|---------|----------|-------------|-----------|----------|---------|
| Cambodia | | Exists | Missing | Exists | Exists | Exists | Missing | Exists |
| Indonesia | Exists | | Exists | Exists | Missing | Exists | Missing | Exists |
| Lao | Missing | Exists | | Missing | Missing | Missing | Exists | Missing |
| Malaysia | Exists | Exists | Missing | | Missing | Missing | Missing | Exists |
| Philippines | Exists | Missing | Missing | Missing | | Missing | Exists | Missing |
| Singapore | Exists | Exists | Missing | Missing | Missing | | Missing | Exists |
| Thailand | Missing | Missing | Exists | Missing | Exists | Missing | | Missing |
| Vietnam | Exists | Exists | Missing | Exists | Missing | Exists | Missing | |

Source: UNCTAD Database, May 2012

The reasons for fewer BITs in South Asia are the political economic impediments discussed earlier in this paper. While it is a reflection of positive bilateral relations, signing of more BITs does not necessarily increase the economic ties and integration between the countries within a region. BITs are essentially instruments to boost investor confidence⁶⁵ and to an extent create the environment for integration. The treaties studied are between India and Bangladesh⁶⁶, India and Sri Lanka⁶⁷, India and Nepal⁶⁸, Indonesia and Lao⁶⁹, Indonesia and

⁶³ For the purpose of this study, “South Asia BIT” refers to the BITs entered between the South Asian nations and “ASEAN BIT” refers to BITs between ASEAN nations.

⁶⁴ UNCTAD, Investment Instruments Online, Available at http://www.unctadxi.org/templates/DocSearch___779.aspx.

⁶⁵ The BITs between India-Sri Lanka and India-Nepal show that investments between these countries have increased after the agreements were signed. On the other hand, despite no BITs with China or the US, India receives highest levels of foreign investment from these two countries. Thus while BITs do boost investor confidence, they are not a necessary determinant of the levels of foreign investment between two countries.

⁶⁶ Agreement between the Government of the Republic of India and the Government of the People’s Republic of Bangladesh for the Promotion and Protection of Investments dated February 9, 2009.

⁶⁷ Agreement between the Government of the Republic of India and the Democratic Socialist Republic of Sri Lanka for the Promotion and Protection of Investments dated January 22, 1997.

⁶⁸ Agreement between the Government of Nepal and the Government of India for the Promotion and Protection of Investments dated October 21, 2011.

Cambodia⁷⁰, Cambodia and Malaysia⁷¹, Cambodia and Philippines⁷², Cambodia and Singapore⁷³, Cambodia and Vietnam⁷⁴, Cambodia and Malaysia⁷⁵, Malaysia and Indonesia⁷⁶, Singapore and Indonesia⁷⁷, Indonesia and Vietnam⁷⁸, Vietnam and Singapore⁷⁹, Vietnam and Malaysia⁸⁰, Philippines and Thailand⁸¹, Thailand and Lao⁸² and Sri Lanka and Pakistan⁸³.

From a content perspective, Exhibit 1 summarizes the key provisions of typical bilateral investment treaties and the general approaches of the South Asia and ASEAN. It is evident that both ASEAN and South Asia BITs largely have similar clauses. Investors are accorded protection either by relative or absolute standards. Under the Most Favored Nation (MFN) clause, the host country is required to treat investors from a contracting party relatively on the same terms as third parties. Under the National Treatment (NT) clause, investors from contracting parties are required to be treated no less favorably than the investors from the host country. The “fair and equitable” clause (F&E) provides an absolute standard under which a minimum standard of treatment must be accorded to investors. Some BITs also provide for “full protection and security” to foreign investors. While none of the South Asia BITs provided for this additional protection, some ASEAN BITs provide for this additional protection⁸⁴. Majority of BITs provide for the MFN and National Treatment protection in the post establishment phase.

⁶⁹ Agreement between the Government of the Republic of Indonesia and the Government of the Lao People’s Democratic Republic concerning the promotion and protection of investments dated October 18, 1994.

⁷⁰ Agreement between the Government of the Republic of Indonesia and the Government of the Kingdom of Cambodia concerning the Promotion and Protection of Investments dated March 16, 1999.

⁷¹ Bilateral Agreement for the Promotion and Protection of Investments between Cambodia and Malaysia dated August 17, 1994.

⁷² Agreement between the Government of Kingdom of Cambodia and the Government of Republic of Philippines dated August 16, 2000.

⁷³ Agreement between the Government of the Kingdom of Cambodia and the Government of the Republic of Singapore on the Promotion and Protection of Investments dated November 4, 1996.

⁷⁴ Agreement between the Government of the Kingdom of Cambodia and the Government of the Socialist Republic of Vietnam concerning the Promotion and Protection of Investments.

⁷⁵ Bilateral Agreement for the Promotion and Protection of Investments between Cambodia and Malaysia dated August 17, 1994.

⁷⁶ Agreement between the Government of Malaysia and the Government of Indonesia for the promotion and protection of investments dated January 22, 1994.

⁷⁷ Agreement between the Government of the Republic of Singapore and the Government of the Republic of Indonesia on the Promotion and Protection of Investments dated February 16, 2005.

⁷⁸ Agreement between the Government of the Republic of Indonesia and the Government of the Socialist Republic of Vietnam dated October 25, 1991.

⁷⁹ Agreement between the Government of the Socialist Republic of Vietnam and the Government of the Republic of Singapore on the Promotion and Protection of Investments dated October 29, 1992.

⁸⁰ Agreement between the Government of the Socialist Republic of Vietnam and the Government of Malaysia for the Promotion and Protection of Investments dated January 21, 1992.

⁸¹ Agreement between the Government of the Republic of Philippines and the Government of the Kingdom of Thailand for the Protection and Promotion of Investments dated September 30, 1995.

⁸² Agreement between the Government of the Kingdom of Thailand and Government of the Lao People’s Democratic Republic for the Promotion and Protection of Investments.

⁸³ Agreement between the Government of the Democratic Socialist Republic of Sri Lanka and the Government of the Islamic Republic of Pakistan for the Promotion and Protection of Investment dated December 20, 1997.

⁸⁴ For example Indonesia and Cambodia BIT–Article II.

All BITs provide certain exceptions with regard to application of the MFN, NT, F&E clauses. Under these exceptions, a contracting party may grant more favorable treatment/preference to a third party under any regional agreement for monetary, tariff, trade matters, customs union or an agreement intended to lead to such a regional agreement or any other arrangement to promote regional cooperation or under any double taxation treaties. Notably, only ASEAN BITs provide such an exception for regional cooperation arrangements. This actually allows ASEAN nations to provide more favorable treatment for purpose of regional integration. Arguably, this reflects a level of commitment of the ASEAN nations towards regional economic integration⁸⁵. South Asia BITs do however allow the contracting parties to take advantage of other more favorable rules in other treaties⁸⁶. Another indicative aspect of the ASEAN BITs is that they visibly emphasize the “*desire to intensify economic cooperation*” between the countries, “*increasing friendly and cooperative relations*” along with stimulating individual business initiatives of the contracting countries. On the other hand, the South Asia BITs appear to emphasize solely on “*stimulating individual business initiatives*”. Since the preamble reflects the development objective of an agreement, its legal construct also suggests the rationale and motivation behind BITs in the two regions. These subtle differences between the BITs in the regions may be considered suggestive of a pro-integration approach of the ASEAN nations.

However, South Asia BITs provide significant extra protection as compared to ASEAN BITs. Exhibit 2 provides a comparative synopsis of the key provisions of the South Asia and ASEAN BITs. For instance, MFN protection applies in most South Asia BITs to both investors and investments while in ASEAN it only applies to investments. Most ASEAN BITs do not provide for NT. There are also other restrictions in the ASEAN BITs not present in the South Asia BITs. Some ASEAN BITs also have a “prohibition and restriction clause” which limits the application of the investor protections provided under BITs. Article 11 of the Cambodia- Singapore BIT⁸⁷ allows a contracting party to take any action to protect the essential security interests, public health or prevent diseases and pests in animals or plants.

It appears that with respect to content, ASEAN BITs are not distinguishably more giving than the South Asia BITs. On the contrary, South Asia BITs have wider protections and limited restrictions. Thus from a legal perspective, it seems unlikely that the content of the BITs impacts the prospects of integration in the region in a significant way. Like any other bilateral agreement, BITs only capture the political and economic relationship between two countries. In fact the recent legal controversies in South Asia, have only highlighted the potential prospect of large stake litigation making it essential to assess the benefits of entering multiple such agreements.⁸⁸ Instead, what seems to have worked for the ASEAN region is better relations between the countries, re-aligned policies and a multilateral approach at various levels.

The Framework Agreement on the ASEAN Investment Area was initiated in October 1998 to create a competitive and liberal investment area. Its main objective is to attain the greater and

⁸⁵ Also note that in comparison, South Asia grants more favorable treatment under bilateral trade agreements instead of the SAFTA.

⁸⁶ Also see Indonesia - Malaysia, Indonesia-Singapore, Indonesia-Vietnam, Singapore-Vietnam.

⁸⁷ Also see Vietnam-Singapore BIT

⁸⁸ In the recent case by Indian tax authorities against Vodafone, the company has alleged that the tax law violates the bilateral investment treaty with Netherlands.

more sustainable levels of foreign direct investment into the region. The ASEAN Comprehensive Investment Agreement (ACIA) was signed on 26 February, 2009, by the ASEAN nations as a consolidated replacement of the previous agreements⁸⁹. The ACIA offered improved and comprehensive set of provisions on liberalization, promotion, facilitation and protection of investments, The ACIA provides for the investment protections including the MFN protection⁹⁰, F&E treatment, full protection and security⁹¹ and protection from expropriation without compensation.⁹² Notably, the ACIA offers many additional protections. For instance, while most ASEAN BITs do not provide for NT, ACIA provides for NT protection with respect to admission, establishment, acquisition, expansion, management, conduct, operation and sale or disposition of investments to both investors and investments. Other protections to investors include a clause prohibiting member states from requiring that senior management positions be filled by persons of a particular nationality⁹³ and a clause which grants foreign key personnel associated with the investment the right of entry and temporary stay⁹⁴. It provides for special and differential treatment for newer ASEAN members. The agreement comprises provisions which require states to endeavour to streamline procedures for investment application, disseminate investment information and rules and establish one stop investment centers. Additionally it has a provision on transparency and on other efforts that ASEAN states should endeavour to take to enhance ASEAN integration.

Several BITs grant protection to only those investments which have been “approved” by the government. This denies investors certainty of protection since the “approval” process may itself be unreasonable or unfair. The ACIA provides greater certainty and transparency in the administrative procedures adopted by each member state in order to approve investments. Member states are required to keep the AIA Council informed of and publish any relevant changes in their laws that affect approval processes for investments.

Political commitment towards integration and concerted efforts towards improvement of the region’s investment climate is required⁹⁵. This will also counter the view that the small size of individual countries in South Asia makes them unattractive investment destinations. Revision of the SAFTA to make it more comprehensive and signing a multilateral investment agreement to improve the investment climate are two steps which will improve the environment for integration in South Asia.

V. Conclusion

⁸⁹ The objective of the ACIA is *"to create a free and open investment regime within ASEAN in order to achieve the end goal of economic integration."*

⁹⁰ Article 6 ACIA

⁹¹ Article 11, ACIA

⁹² Article 14, ACIA

⁹³ Article 8, ACIA

⁹⁴ Article 22, ACIA

⁹⁵ Political considerations impact investment flows in the region. The proposed investment of \$2 billion by India’s Tata Group in Bangladesh in steel, fertilizer and power plants was shelved due to political reasons. Similarly the bid by Indian construction and power project developer GMR Group to develop Nepal’s 300 MW Upper Karnali hydro power plant through a joint venture with the Nepal Electricity Authority also met with political and public opposition.

Promoting regional integration in South Asia entails efforts in key areas such as infrastructure, trade facilitation, investment, governance and implementation. The most critical element of the integration process in South Asia is building confidence and filling the huge trust deficit between the countries. Economic interests (i.e. the potential of increasing trade and investment) and strategic interests (i.e. better positioning to have a say in global governance) have the potential of uniting South Asian countries, sidelining political differences to pursue regional integration. With increased political will and commitment towards integration, greater efforts will have to be made towards integration. In this respect, India will have to take on disproportionately greater responsibility while the other South Asian countries will have to commit to cooperation and openness. SAARC needs to be reinforced and be a professionally staffed institution. Like the ASEAN, SAARC needs to assume a central role in creating conditions for deeper integration by promoting investment, trade, transparency, harmonizing standards and simplifying procedures through a multilateral process. Additionally, measures of soft diplomacy should be adequately utilized to mould public opinion, bring South Asians closer and create an understanding of the value of increasing regional integration and cooperation. Agreements such as the SAFTA need to be made more meaningful with appropriate emphasis on non tariff barriers and strict timelines for tariff reduction. Ideas such as focusing on priority industries to build complementarities need to be explored. The changing dynamics in region and the world economic order make this an opportune time for South Asian countries to change their approaches and strategies towards each other.

Exhibit 1. Summary of key provisions of BITs

| Key Clauses | Typical Provision | Application | Variation |
|--|--|--|--|
| 1. Definitions | <p>Investment – Asset based definition and non exhaustive list of what all is comprised in an investment.</p> <p>Investor – includes natural persons and legal persons of the contracting parties</p> | All BITs have the same definitions. | Instead of “Investor”, the terms “Nationals” and “Companies” are used in some agreements (eg. Cambodia-Philippines). |
| 2. Treatment | | | |
| (i) National Treatment (NT) | Treatment accorded to investments/investors is no less favorable than that accorded to investments/investors of the host country. | <p>South Asia – NT been provided only to investments, returns on investments but not to investors.</p> <p>ASEAN– Most BITs do not have a NT clause.</p> | |
| (ii) Most Favored Nation (MFN) | <p>Treatment accorded to investors/investments (of one contracting party) in the host country is no less favorable than the treatment accorded to investors/investments of a third party.</p> <p>Generally both MFN and NT apply at the post establishment stage.</p> | <p>South Asia – MFN is provided for both investors and investments.</p> <p>ASEAN – All BITS provide MFN with respect to investments.</p> | |
| (iii) Fair and Equitable Treatment (F&E) | <p>Fair and equitable treatment to be accorded to investors/investments.</p> <p>Also provides for protection and security of investments.</p> | <p>South Asia - F&E applies to investments and returns on investments.</p> <p>ASEAN – F&E applies to all investments.</p> <p>Additional protection and security is provided to investments in majority ASEAN BITs.</p> | |
| (iv) Exceptions | <p>There are certain exceptions to the MFN and NT clauses. More favorable treatment may be granted to third parties under:</p> <ul style="list-style-type: none"> - Existing or future customs, monetary, tariff or trade arrangements - Other regional cooperation arrangements - Double taxation treaties | <p>South Asia – BITs do not provide the exception for regional cooperation arrangements.</p> <p>ASEAN – Most BITs provide for all three exceptions.</p> | |
| 3. Protection of Investors | | | |

| | | | |
|--|---|---|--|
| (i) Loss due to internal disorder (i.e. losses suffered owing to war or other armed conflict, state of national emergency or civil disturbances) | In the event any losses are suffered due to internal disorder, treatment accorded to investors with respect to restitution/indemnification/compensation shall be no less favorable than the treatment of the host country's investors or investors of a third party. | South Asia – provides for no less favorable treatment than that accorded to host investors and third party investors. ASEAN – only provides for no less favorable treatment than that accorded to third party investors ^[1] . | |
| (ii) Expropriation | Generally the clause provides that investments shall not be nationalized/expropriated except for a public purpose, in accordance with law and on a non discriminatory basis and against fair and equitable compensation. Payment must be prompt, adequate and efficient. Measure of compensation is equivalent to fair market value of the investment expropriated immediately before the expropriation or before the impending expropriation became public knowledge. Interest is calculated at a commercially reasonable rate. | All BITs have provisions on Expropriation. | Indonesia treaties allow expropriation for a lawful purpose not specifically “public purpose” ^[2] . In the Malaysia – Indonesia BIT, for any unreasonable delay in payment of compensation, payment of interest is required. In the Cambodia - Singapore BIT, for Cambodia, the valuation is determined by an international independent appraiser selected by both contracting parties. |
| 4. Transfers/Repatriation | Clause provides a commitment to free transfer without delay. The illustrative list of funds that may be transferred includes net operating profits, repayments of loans, proceeds from sale of shares, payment of royalties, capital and additional capital amounts used to maintain /increase investments, remuneration of employees, compensation. | All BITs have this provision. | |
| 5. Subrogation | | All BITs have this provision. | |
| 6. Entry and sojourn of personnel | Entry of personnel is allowed for the purpose of engaging in activities connected with investments. | South Asia BITs have this provision. | |

| | | | |
|--|--|---|--|
| 7. Settlement of Disputes between investor and contracting party or between contracting parties | Diplomatic Consultations, Arbitration | All BITs have this provision. | |
| 8. Application of Other Rules | Treatment more favorable than that provided under an agreement is permissible where there are other more favorable agreements. | Majority ASEAN and South Asian BITs allow application of other more favorable provisions. | |
| 9. Retrospective Application of the BITs | Under this clause, investments made prior to entry in force of the BIT will be covered under the BIT. | Majority ASEAN and South Asian BITs allow retrospective application. | |

[1] BITs providing for no less favorable treatment than that provided to its own nationals are: Cambodia and Vietnam BIT

[2] Also Cambodia and Singapore BIT.

Exhibit 2. Comparison of provisions of South Asia and ASEAN BITs

| Contracting Parties | Treatment | | | | | | | Protection | | | Transfer | Subrogation | Dispute Settlement | | Application to investments/ disputes prior to agreement | | |
|--------------------------|-----------|------------|----------|------------|----------|------------|-------------------------|------------|--------------------------------|---|----------|-------------|--------------------|-------------------|---|----------------|--|
| | MFN | | NT | | F&E | | | Exceptions | Expropriation | | | | Internal disorder | State v. Investor | | State v. State | |
| | Investor | Investment | Investor | Investment | Investor | Investment | Protection and security | | Public purpose/ lawful purpose | Prompt, adequate and effective compensation | | | | | | | Rate (FMV before expropriation becomes public knowledge) |
| Cambodia and Philippines | | ✓ | | | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | not applicable | | |
| Cambodia and Singapore | | ✓ | | | ✓ | | ✓ | ✓ | ✓ | ✓ ^[1] | ✓ | ✓ | ✓ | ✓ | applicable | | |
| Cambodia and Vietnam | | ✓ | | | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | not applicable | | |
| Cambodia and Malaysia | | ✓ | | | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | applicable | | |
| Malaysia and Indonesia | | ✓ | | | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | applicable | | |
| Singapore and Indonesia | | ✓ | | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | applicable | | |
| Indonesia and Vietnam | ✓ | ✓ | | | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | applicable | | |
| Vietnam and Singapore | | ✓ | | | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | applicable | | |
| Vietnam and Malaysia | | ✓ | | | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | applicable (investments from January 1, 1988) | | |

| | | | | | | | | | | | | | | | | | |
|--|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|--|
| Philippines and Thailand | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | applicable |
| Indonesia and Cambodia | | ✓ | | | | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | not applicable |
| Indonesia and Lao | | ✓ | | | | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | applicable |
| Thailand and Lao | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | applicable |
| India and Bangladesh | ✓ | ✓ | | ✓ | | ✓ | | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | applicable to investments made after January 1, 1980 |
| India and Sri Lanka | ✓ | ✓ | | ✓ | | ✓ | | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | applicable |
| India and Nepal | ✓ | ✓ | | ✓ | | ✓ | | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | not applicable |
| Pakistan and Sri Lanka | | ✓ | | ✓ | | ✓ | | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | applicable (under conditions) |
| ASEAN Comprehensive Investment Agreement | ✓ | ✓ | ✓ | ✓ | | ✓ | | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | not applicable |

[1] Cambodia - value shall be as determined by independent mutually selected appraiser. Singapore - value immediate before expropriation.

