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Informal Trade in South Asia

How to channelise to a formal route?

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Two key issues are at the forefront when studying informal trade in the South Asian region: a) the magnitude of such trade flows, and b) the factors underlying it. Quantitative estimates are crucial since they reflect the extent of potential trade that exists in the region. Moreover, it is important to understand the institutional mechanism that drives informal trade: how it differs from formal trade, and why such trade takes place at all.

To the extent that high tariffs and non-tariff barriers encourage the use of informal channels, bilateral/regional free trade arrangements (FTAs) would induce a shift of trade flows from informal to formal trade channel. However, if it is factors other than trade policy distortions that determine informal trade, then a deeper understanding is needed. Thus, as long as the transacting environment for informal trading is more efficient than that of formal trading, the former may continue to co-exist with the latter. It is useful to classify factors determining informal trade flows into two broad categories: a) trade policy barriers, and b) institutional and other factors.

Background

The importance of studying informal trade in South Asia can best be understood if it is placed in the context of formal trade. The South Asian countries have made several attempts at enhancing trade in the region under the aegis of the SAARC (South Asian Association for Regional Cooperation) formed in 1985. In 1991, a South Asian Preferential Trading Arrangement (SAPTA) amongst the SAARC member countries was made with the ultimate goal of achieving a South Asian Free Trade Area (SAFTA). The signing of the SAFTA at the 12th SAARC Summit held in Islamabad paved the way for its implementation by January 2006. In addition, there have been several bilateral FTAs within the region. India has FTAs with Bhutan, Nepal and Sri Lanka. Similarly, FTAs are being negotiated between Pakistan and Sri Lanka, and between Bangladesh and Pakistan.

Despite such efforts by the South Asian countries, formal trade within the SAARC region continues to be abysmally low. Available evidence suggests that informal trade is rampant, and if such trade is brought within the ambit of formal (official) trade, a significant increase could be witnessed. However, this will largely depend on the nature of informal trade, which is discussed later.

While analysing issues related to informal trade it is crucial to define such trade flows. Informal trade or unrecorded trade is broadly defined to include all trading activities between any two countries, which should be included in the national income according to national income conventions but are presently not captured in official national income statistics.

Since India, the central actor in informal trade in the region, is the only country, which shares its border with almost all the South Asian countries and at the same time no country shares its border with countries other than India, the modalities of informal trade vary with border characteristics. Informal trade could be carried out by land, sea and/or air. India shares a long and porous border with Bangladesh, Nepal and Pakistan.

Prior to liberalisation in the 1990s, for almost two decades, a large part of informal trade between India and Nepal could be attributed to air travelers. In recent years, profit margins have declined and movement of goods by air passengers has become unviable. Therefore, land has become the predominant route for this informal trade.

As Bangladesh is sandwiched between the north-eastern region and the West Bengal borders of India, informal trade between India and Bangladesh takes place along both the borders. Informal trade between India and Sri Lanka takes place mainly by air passengers, with a small proportion being carried out by sea through country boats. Historically, the sea-route between the coastal areas of Jaffna (in Sri Lanka) and those of Tamil Nadu (in India) has been the most crucial passage for informal trade. However, a dramatic change occurred after the civil war in Sri Lanka in the early 1980s, as the subsequent heavy naval patrolling made it difficult to trade informally by sea. This situation continues even today which explains why informal trade through the sea-route is so low, albeit it would be far more cost effective.

Perhaps, the Indo-Pak trade modalities are the most interesting. A large part of informal trade takes place via third countries as only a limited number of items are permitted to be imported into Pakistan from India. Thus, goods move officially from India to Dubai. These goods are then shipped to Bandar Abbas (in Iran) from where the goods are moved informally via land route across Afghanistan into Pakistan. A smaller amount is traded by the sea route to Karachi from Dubai. Informal trade along the land route is the least and is carried out through the Amritsar-Lahore (two sides of Punjab) and Sind-Rajasthan border routes. On the Lahore route, informal trade mainly takes place through passengers travelling on the 'Samjhauta Express' (only rail link between India and

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Table 1: India's Informal & Formal Trade with South Asian Countries (in US$ million)				
	Exports Informal (formal) 706.2 (1646.7)	Imports Informal (formal) 779.2 (403.5)	Trade Balance Informal (formal) 934.6 (1243)	Total Trade Informal (formal) 1485.5 (2050.1)
Bangladesh (1992-93) [1, 2]	299.0(349.1)	14.0 (7.8)	285.0 (341.2)	313.0 (356.9)
Sri Lanka (2000-01) [3, 4]	185.5 (640.2)	21.8 (45.0)	163.7 (595.2)	207.3 (685.2)
Pakistan (2004-05) [5, 6]	10.4(509.3)	514.2 (92.7)	503.8 (416.6)	524.6 (602.0)
Nepal (2000-01) [7, 8]	180.0(141.0)	228.0 (255.0)	-48.0 (-114.0)	408.0 (396.0)
Bhutan (1993-94) [9, 10]	31.3(7.0)	1.2(3.0)	30.1(4.0)	32.6 (10.0)

Pakistan) while on the Sind route it is done along the land border. These mechanisms ensure that trade between the two countries does not enter into the official trade statistics of either country.

Magnitude & Composition of Informal Trade

The only method to estimate informal trade flows is through primary surveys. Some studies, from time to time, have been undertaken to estimate informal trade flows of different countries in South Asia. However, no set of estimates pertaining to a particular point in time exists. This paper provides the latest estimates available on informal trade. Chaudhuri (1995) made the first study to provide estimates of informal trade between India and Bangladesh using the *Delphi technique*. Subsequently, the technique was modified to estimate informal trade between India and Nepal and between India and Sri Lanka (Taneja *et. al*. 2002). A study by Khan *et. al*. (2005) is the first systematic attempt at estimating informal trade between India and Pakistan on the basis of an extensive primary survey. Estimates for Bhutan are based on primary surveys, but the methodology is not clear.

On the basis of these studies, some interesting features of the magnitude of informal trade come to light. Total informal trade in the South Asian region is about US$1.5bn, which is 72 percent of formal trade for corresponding years for which estimates are available (see Table 1). India's informal trade with Nepal and Bangladesh is almost as large as the formal trade, with Pakistan it is 87 percent of formal trade, with Sri Lanka it is almost one-third and that with Bhutan is three times. Interestingly, of the US$525mn informal trade with Pakistan, almost half is traded officially first to Dubai and then to Pakistan via Iran and Afghanistan.

Another noticeable feature is the fact that India has a trade surplus with Bangladesh, Pakistan, Sri Lanka and Bhutan on the unofficial trade account, while with Nepal it has an almost balanced trade. Also important is the fact that the commodity baskets being traded formally and informally are different. While a large part of informal imports into India comprise of third country goods, informal exports to the South Asian countries consist of essential goods (both food and non-food) and mass scale consumer items.

Why Informal Trade Takes Place?

Trade barriers restrict official trade flows to a large extent. Any removal would lead to a shift in trade flows from informal to formal channels. By the same logic, if informal trade is driven by factors that do not fall under the purview of FTAs, then informal trade will persist in the region.

Trade Policy Distortions

High tariff levels and tariff differentials within the South Asian region encourage informal trade. Even though SAFTA lays down criteria for rules of origin (RoO), high tariff differentials between Member countries create a strong incentive to avoid the formal channel. Tariffs in India, Bangladesh and Pakistan have been high through the 1990s. In the early 1990s, the unweighted tariff average was highest for Bangladesh at 79 percent followed by Pakistan 59 percent and India 51 percent. Tariffs were relatively lower in Sri Lanka (27 percent) and in Nepal (14 percent).[11] In 2000, the average tariffs were highest in India at 39 percent followed by Pakistan 25 percent, Bangladesh 20 percent and Sri Lanka 15 percent.[12]

In recent years, tariff levels have fallen and the difference in tariff levels between India and its neighbours has narrowed down. As a result, informal imports into India from third countries have fallen considerably but informal exports from India to the South Asian countries have declined marginally. Informal exports from India to Sri Lanka increased from US$135mn in 1992[13] to US$232mn in 1996[14] and then declined to US$186mn in 2000-2001. Informal imports from Sri Lanka to India have been falling consistently during the same period: from US$114mn in 1992, to US$45mn in 1996 and then further down to US$22mn in 2000-01. Informal imports from Nepal to India were worth US$626mn in 1990[15] while in 2000-01 it was down to US$228mn .

In the 1990s, the presence of non-tariff barriers in the form of quantitative and other restrictions has encouraged informal trade in the region. India and Bangladesh had the highest NBT coverage ratio for primary and manufactured goods (66 and 52 percent, respectively). In recent years, quantitative restrictions have come down considerably to the extent that trade in the region is obstructed by NTBs and therefore, a shift to formal channels is likely to occur.

Institutional and Other Factors

In order to go beyond the conventional role of trade policy barriers in influencing informal trade flows, it is useful to understand the functioning of informal and formal trading markets. Under formal trading arrangements, the recourse to law defines contracts between two trading parties ensuring that goods move across borders legally and payments are guaranteed. On the other hand, contracting parties in informal trade cannot resort to the law for violation of terms of contract. Consequently, it is reasonable to assume that individuals trading through the informal channel have devised parallel institutional mechanisms for contract enforcement and dispute settlement. Also, the smooth functioning of such markets show that traders have developed efficient mechanisms for obtaining information on quantities and commodities to be traded and mitigating risks that might arise from the transacting environment.

In contrast, it is important to understand the institutional structure supporting formal trade whereby exchange is affected by factors which are not related to the physical process of production, such as administrative processes, government rules and regulations, infrastructure bottlenecks, etc. Thus, if the intuitional arrangement under informal trading is more efficient than that under formal trading, traders may prefer the former rather than the latter.

The inadequate transport and transit systems, which have been in existence between India and her neighbouring countries, have led to high transportation costs in the region. In fact, transport costs of trading within South Asia are far higher than those in the rest of the world. A large part of trade, therefore, takes place informally. Thus, as long as transport costs are higher in the formal channel than those in the informal channel, the latter will continue to flourish.

Besides, there are other transaction costs that emanate from the trading environment of formal and informal trading. Informal trading markets, devoid of any formal contracts between trading partners, function smoothly, though there are costs that have to be incurred to mitigate the risk associated with such transactions. Surprisingly, risk in informal trading has been found to be extremely low. For instance, in Indo-Bangladesh informal trading, the probability of goods being seized, was less than 0.1 while that in Indo-Nepal and Indo-Sri Lanka informal trading was still lower at 0.03.[16] In fact, even though goods are seized, they can be recovered against nominal payments.

On the other hand, formal trading procedures are extremely complex in the South Asian region where poorly designed institutions do not provide traders with a predictable framework and necessary business information. Such institutions increase transaction costs for trading through the formal channel. For instance, the number of documents that need to be filled up for trading is 29 for India, 83 for Nepal and 15 for Pakistan.[17] Also clearances have to be obtained from multiple agencies at various stages of trading, including obtaining licences and getting clearances from banks. Such procedures not only involve incurring costs in terms of time taken but also lead to rent seeking activities. Traders are made to pay hefty bribes at various stages of trading before their goods can finally reach their destination.

Intrinsic to the activity of trading is the issue of payments. Formal banking facilities are not only inadequate in the region but also the banking procedures are very time consuming. Traders have to wait for a long period before their payments can be realised while the informal banking system is very organised and payments are not only ensured but are also very quick. The uniqueness of the informal banking system is non-physical transfer of currency. This mechanism, referred to as *Hawala* in India and Pakistan, *Hundi* in Bangladesh and *Undiyal* in Sri Lanka, operates on the same principles. Partner country currencies are easily convertible in the informal money market making it possible for traders to trade in different currencies. In fact, the informal banking is so efficient that payments can be received within a day. Traders may, therefore, prefer to exploit the informal channel, as it has a better payments mechanism than that in the formal channel.

Perhaps what lie at the core of informal trading markets are the close ethnic ties. A common language, religion, culture, etc plays a crucial role in facilitating trading across the border. Ethnic ties amongst trading partner countries not only ensure that payments are made but also go towards reducing risk and transaction costs in carrying trade across borders. It has been observed that in Indo-Nepal, Indo-Bangladesh and Indo-Sri Lanka trade, ethnic ties are stronger in the informal channel than those in the formal channel.[18]

In some cases, low literacy deters traders from using the formal channel. Also, lack of education precludes traders from having information on the details of different trading arrangements. Under such conditions, traders would prefer to use the informal channel. It has been found in various studies that in Indo-Nepal, Indo-Bangladesh and Indo-Sri Lanka trading, levels of education among formal traders are significantly higher than those of informal traders.[19]

Informal to Formal: Need for Institutional Reforms

It is evident that informal trade in the region is quite large and cannot be ignored in any policy dialogue. The Framework Agreement for SAFTA signed at the 12th SAARC Summit did not address this issue. Informal trade between India and Pakistan is an area, which needs to be addressed urgently. As the two countries are moving closer to improve trade relations, it is important to recognise the functioning of informal trade markets and the inadequacies of the formal trading channel.

The Indo-Sri Lanka Comprehensive Economic Partnership Agreement (CEPA) signed recently, includes trade in services, corrects the anomalies of the currently operational Indo-Sri Lanka FTAs but makes no attempt to look into the issues of informal trade. India and Nepal have a long history of bilateral FTAs signed since 1961,

Box 1: Ethnic Ties & Informal Trade

The South Asian countries share a common language, religion and culture. Ethnic trading networks play a critical role in facilitating informal trade flows. This is particularly so where the same ethnic community is divided into two national boundaries: for example, the division of Bengal nation into Bangladesh and West Bengal state of India and the division of Punjab into Indian and Pakistani states of Punjab. The largest single ethnic group engaged in Indo-Lanka informal trade is the hill-country Tamils who migrated from Southern India (overwhelmingly from the state of Tamil Nadu) to Sri Lanka in the late 19th and early 20th centuries to mainly work as labourers in the plantation sectors of Sri Lanka. The informal trade between India and Nepal is controlled by the Marwaris who migrated from India to Nepal about 125 years ago.

Ethnic and kinship ties across the border facilitate information flows on goods and quantities to be traded. Such ties enable non-anonymous trading and ensure that goods are delivered across the border and payments are made. Thus, ethnic and kinship ties are the institutions through which traders minimise risk and reduce their transaction costs of (informal) trading.

but these agreements have focused only on unauthorised trade in third country goods, with clear reference to flow of goods informally from Nepal to India. It is not widely known that informal trade from India to Nepal in locally produced goods is of equal magnitude and cannot be ignored in bilateral talks. The bilateral FTA between India and Nepal was renewed in 2002 but did not recognise the importance of the two-way informal trade flow.

There is no doubt that the implementation of SAFTA and other bilateral trading arrangements would lead to a reduction in informal trade flows. The incidence of informal trade, particularly in goods from third countries into India, has come down with the lowering of tariffs in the region. For instance, in 1991, informal trade in third country goods from Sri Lanka to India was almost as large as informal trade from India to Sri Lanka. A decade later, there has been a considerable reduction in informal trade in third country goods from Sri Lanka. Informal trade in third country goods from Nepal to India was almost 10 times that of formal trade in 1990 while recent estimates show that such trade has come down considerably. Further reduction and harmonisation of tariffs would reduce the incidence of informal trade.

Clearly, the reform process in the South Asian countries should undertake institutional reforms so that transaction costs can be lowered. This would also have a much larger impact in the form of trade expansion from and within the South Asian region. Information is another important aspect, which has to be looked into. It is true that a major proportion of informal traders are locals who do not have high levels of education or are only conversant with local languages. Such gaps have to be filled by suitable dissemination of information and creation of awareness.

Concluding Remarks

It is evident that the institutional mechanism in the informal trading market facilitates informal trade. The channels through which informal trade takes place are rooted in strong ethnic ties among the traders and in historical linkages in these societies. Ethnic trading networks that operate on trust and honesty mitigate risks associated with such trading. The involvement of law enforcement agencies to collect rents (thereby mitigating informal trading risks) makes the transacting and transporting processes smooth and acts as an added incentive to carry on informal trade.

It is easily perceived that informal trade under these circumstances would be difficult to eliminate. While it can well be argued that if the transacting environment for informal trading is more efficient than for formal trading, why not let it continue - the danger is that the associated money laundering to finance such trade deals might prove to be a threat to the smooth functioning of formal capital markets. A focus on law enforcement agencies to detect and obstruct informal transit of goods across borders is not a viable solution, as they would increase enforcement mechanisms, which could only lead to increase in rent collections. What would be more effective is to reduce the impediments to trade in the formal channels. Time delays due to unnecessarily long and complicated procedures need to be reduced by simplifying procedures.

In sum, informal trade is unlikely to be totally eliminated because ethnic networks between trading partners would continue to facilitate it by reducing transaction costs through minimisation of risks, market information and search costs. Further reduction of tariffs, improvements in the transacting environment of formal trade, improving awareness and education levels are required in order to channelise informal trade to the formal route.

Endnotes

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