# Gains from Trade and Structural Impediments to India-Pakistan Trade

**By**

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## Introduction

India and Pakistan have been reluctant trading partners. Although bilateral trade between the two countries has increased in recent years, obstacles remain in the realization of trade potential. When, in 2006, Pakistan ratified the South Asian Free Trade Agreement (SAFTA), this was seen as a breakthrough, considering that India-Pakistan trade has been the primary stumbling block for greater economic integration of the SAARC region.

Whether trade relations between the two countries improve or not in the foreseeable future, the critical question to ponder over is why Pakistan and India are perhaps the only two large neighbours having such restricted trade relations. In an environment where both countries have liberalized their economies and signed up to the WTO, signifying an explicit statement of their belief in opening up their trade regimes, the low levels of trade are an aberration.

The implications of India-Pakistan trade go well beyond trade and economic calculations. The long-standing geo-political conflict between the two countries has led international observers to classify this region as one of the most volatile in the world. Enhanced trade holds the promise of dilution of animosity, with peace spillovers for South Asia and the rest of the world. At the national level, the peace dividend is expected to accrue as a result of diverting resources from security to development.

The above situation raises three important questions. First, if there are gains to be made from trade by both sides, then why do business interests in both countries not push for greater trade? Second, is it necessary (even if not sufficient) that enhanced trade relations will lead to a reduction in the geo-political tensions in the region? Third, by the same token, will a peace dividend for the domestic economies of India and Pakistan necessarily accrue as a result of increasing trade?

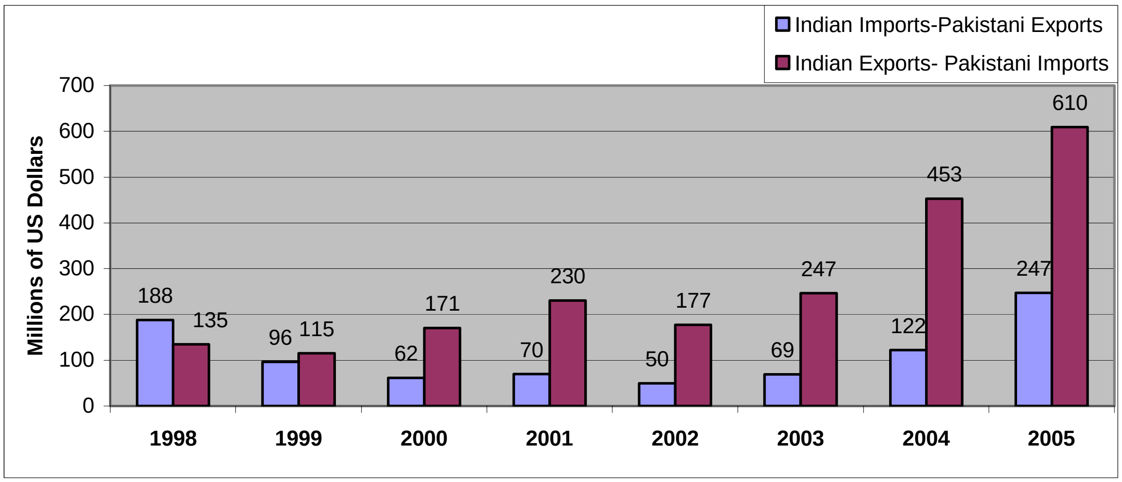
This paper attempts to tackle only the first question. A proper understanding of winners and losers in either country will contribute to a better understanding of the factors inhibiting trade. Both among the business lobbies and the state, there are some who stand to benefit and some who stand to lose from the opening up of trade relations. It is thus important to review the nature of state-business relations in the two countries, in an international developmental context as well as in a historical structural context.

The paper is divided into three sections. In the first section, the pattern of formal and informal trade will be ascertained with the help of secondary data, based on which the paper will attempt to show the gains from trade that could possibly accrue to both sides. The second section will provide a critical appraisal of economic and political factors, both official and unofficial, that have impeded the development of a more open trade regime. The third section homes in on the nature of state-business relations in India and Pakistan to understand the structural reasons for trade barriers.

## 1. Level of Trade between India and Pakistan

The level of trade between India and Pakistan has averaged less than $ 1 billion in the past decade or so (see Figure 1).[1] Given the magnitude of their global trade volumes, two facts point to the low volume of trade between the two countries -- first, neither country falls in the category of the top ten trading partners for each other (SBP, 2006, p.10); and second, between 1999 and 2004, India's share in Pakistan's trade (both imports and exports) averaged less than two per cent, and Pakistan's share in India's trade averaged less than one per cent (SBP, ibid).

**Figure 1. India-Pakistan Trade Flows (1998-2005)**




Source: *IMF, Direction of Trade Statistics (2006)*

Not only is the overall trade level low, but also much of the official trading takes place in an exceptionally narrow band of commodities. Figures 2 and 3 show the major groups of commodities that are traded between India and Pakistan. There are only four major commodity groups being traded currently. The chart also reveals that the bulk of India's exports to Pakistan are in intermediate goods -- chemicals, rubber and plastics[2] -- whereas Pakistan's exports to India are concentrated in primary products and, to a lesser extent, in textiles.[3] [4]

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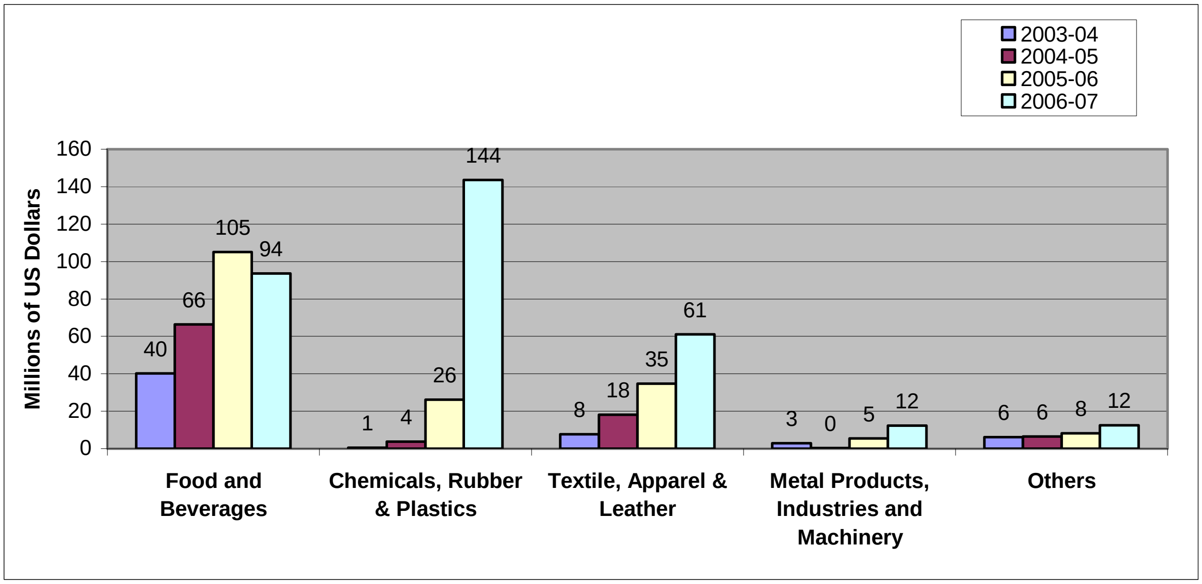
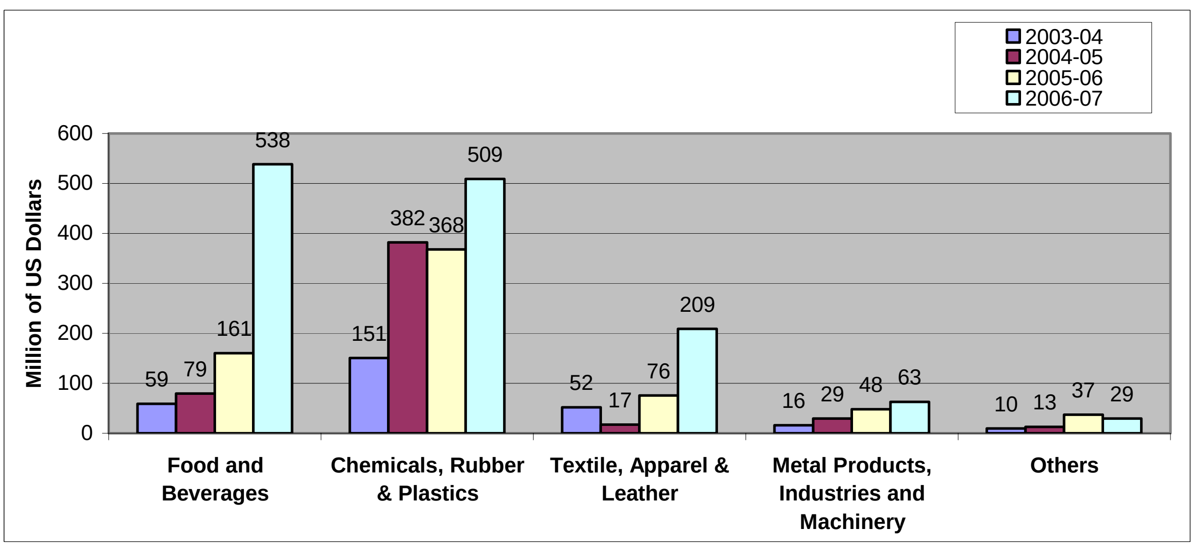
[1] Latest figures available at the time of writing are for 2005.
[2] Note that the large jump in 'Food and Beverages' imports by Pakistan in 2006-07 is driven by the increase in sugar imports, and is a non-recurring phenomenon.
[3] Note that the large jump in 'Chemicals, Rubbers & Plastics' exports by Pakistan in 2006-07 is driven by the increase in mineral fuels, oils, and other products.
[4] See SBP (2006, pp 11-12) for a detailed description on this theme.

**Figure 2. Pakistan Exports-India Imports**




Source: *Department of Commerce India, EIDB (2007)*

**Figure 3. Indian Exports - Pakistani Imports**




Source: *Department of Commerce India, EIDB (2007)*

For economies that were integrated till 1947, formal economic integration was exceptionally low after partition, when India devalued its currency in 1949 and Pakistan did not. Before that, 56% of Pakistan's exports and 32% of its imports were to and from India (Nabi and Nasim, p 175). A further break in trade occurred during the 1965 war.[5] Regions constituting West Pakistan, previously known as the 'granary of India', exported food grains, cotton, spices and dry fruits to areas constituting present day India, whereas imports from pre-partition to present day Pakistan comprised of coal and iron as well as a large variety of finished products (Burki and Akbar, 2005, p 172). The notable point is that the mix of commodities traded before partition and at present remains much the same.

*Informal Trade: Forms and Magnitude*

Informal trade between Pakistan and India takes two forms. The first is what is usually referred to as smuggling, i.e. illegal trade through borders between the two countries.[6] The second is trade through a circuitous route. This usually takes the form of containerized trade, where goods are shipped to a second country, the documentation on origin of goods is changed, and then they are further shipped to the destination country. The other route is when goods are shipped from country A to country B, destined for country C, from where they are re-exported to country D. Much of the informal trade between Pakistan and India takes place through such circuitous routes.[7]

There are a variety of estimates of informal trade between the two countries. These generally range between US $ 1-2 billion. A 2005 study by the Sustainable Development Policy Institute is the only study that has attempted to empirically track all the avenues of informal trade. The study estimates that informal trade for the year 2004-05– through both the third country as well as cross-border routes-- was US $ 545 million. According to this study, imports from India amount to a staggering US $ 534.52 million, while exports to India from Pakistan count for a mere $10.36 million. The breakdown of informal imports from India to Pakistan is given in Table 1. Much of this trade takes place in commodities that are not on the positive list and which are in high demand in Pakistan. The leading sector is cloth – mostly silks – followed by pharmaceuticals, textile machinery, tyres, cosmetics and jewellery.

**Table 1: Informal Trade from India to Pakistan**

| Items | Value (US $ millions) |
|---|---|
| Cloth | 186.0 |
| Pharmaceutical and Textile Machinery | 75.0 |
| Tyres | 73.3 |

[5] The level of integration up until that point can be gauged from the fact that Indian residents still owned and operated businesses in Pakistan. I was informed of this by the late Vineet Virmani, former member, India-Pakistan Chamber of Commerce and Industry and former President, Punjab, Haryana, Delhi Chamber of Commerce and Industry, in an interview dated 6th December, 2005.

[6] This trade takes place through the Amritsar-Wagah route in the north and the Mumbai-Karachi route through boats and through the borders in Rajasthan and Gujarat with Sindh in Pakistan. (see SDPI, 2005).

[7] The circular routes are: India-Dubai-Bandar Abbas (Iran)-Afghanistan-Bara (NWFP, Pakistan), India-Dubai-Bandar Abbas-Afghanistan-Chaman (Balochistan, Pakistan), Mumbai-Kabul-Bara and Afghan transit trade that lands in Pakistan, goes to Afghanistan and then lands back in Pakistan through the land route. Third country routes most frequented are India-Dubai-Karachi, other ones are India-Singapore-Karachi and India-Hong Kong-Karachi routes. For details, see SDPI (2005).

| | |
|---|---|
| Cosmetics & Jewellery | 63.8 |
| Livestock | 33.3 |
| Medicines | 32.8 |
| Herbs & Spices | 24.9 |
| Electroplating Chemicals | 15.0 |
| Biri | 8.6 |
| Others | 6.0 |
| Auto Spare Parts | 5.3 |
| Blankets | 5.0 |
| Ghutka and Paan Masala | 3.3 |
| Razor Blades | 2.2 |
| **Total** | **534.5** |

*Source: SDPI (2005), p18*

That informal trade between the two countries is virtually uni-directional, overwhelmingly from India to Pakistan, is not surprising for two reasons. First, since India has granted MFN status to Pakistan, most of Pakistan's exports are routed through the formal channel. Second, since India's exports are concentrated in high value-added manufactures, their unit values are expected to be higher.

*Estimations on Potential Trade*

The first order observation will be to gauge the gains from trade to both sides on the basis of current formal as well as informal trade levels. This approach, however, does not take into account potential backward and forward linkages that are created, and which expand the total volume of goods traded. For two neighbouring countries with similar per capita incomes and overlapping cultural attributes (particularly between northern India and the Punjab and Sindh provinces of Pakistan), the probability of non-tradeables eventually converting into tradeables is also very high (Nabi and Nasim, 2001, p 177).

Based on these trade expectations, there have been a number of projections that place trade potential between the two countries in the range of US $ 10-15 billion annually.[8] The State Bank of Pakistan (SBP 2006), based on a simple methodology of comparing one country's exports to the rest of the world with the other's imports from the rest of the world, has identified sectors where the potential for trade in a static sense is high. This exercise reveals that based on the 2004 trade data, overall trade would go up to US $ 5.2 billion, with Pakistan's exports constituting US $ 2.5 billion and exports from India to Pakistan constituting US $ 2.7 billion without trade barriers.[9] It also puts into perspective the issue of inequality in bilateral trade relations. Even if Pakistan runs a large trade deficit with India, its import bill will reduce by US$ 400-900 million (ibid, p 21).[10]

[8] KCCI (1996).
[9] For a detailed methodology of calculation, see SBP (2006) pp24-30 and Annexures 5 and 6
[10] A similar estimate for India is not given.

Based on the above exercise, SBP (2006) identifies the following areas where either side can enhance its exports to the other. Pakistan's exports to India can be increased in the following commodities:[11]

- Textiles and related products
- Prepared foodstuff
- Mineral Products
- Rubber
- Vegetable Products
- Power

Likewise, imports from India where trade increase is seen to be significant are:

- Tea
- Spices
- Auto parts
- Light engineering
- Tyres and transport equipment
- Entertainment
- Health care
- Information technology
- Pharmaceuticals

*Gains from Trade*

The static scenario presented above touches the tip of the iceberg in terms of possible gains from trade to both sides. This expansion is predicated on the historical contiguity that existed between different regions of the two countries. Several scholars (Burki and Akbar:2005; Nabi and Nasim:2001) have documented historical links between the Indian and Pakistani Punjab. Similarly, links between Karachi and Mumbai, and from Rajasthan and Gujarat into parts of Sindh were central to the local economies. Several informal trade routes continue to be operated by people on either side who have links with the other side of the border, some of which go back to pre-partition days. If normal trade links are restored, regional economic benefits that can accrue on either side will have a multiplier effect.

Several segments of the Pakistani economy that stand to benefit from increased trade with India have been identified. Firstly, expansion in the volume of trade as a result of access to a larger market will lower unit costs for Pakistani exporters, which will improve their overall competitiveness (SBP, 2006).[12] Secondly, consumers in Pakistan will clearly

[11] In an interview with Anjum Nasim, one of the co-authors of this report, he stated that at the time when their study was being carried out (1995-96), the Pakistani spare parts sector was relatively more competitive than its Indian counterpart simply because Pakistan was a more open economy for a longer time than India at that time. India's engineering sector has now caught up. This goes to show that time lost in liberalizing trade can alter comparative advantage very fast in a fast changing world. Interview conducted in November 2005

[12] This position was endorsed by a textile mill owner, Mr. Arif Saeed, November 30, 2005 in Lahore.

benefit as prices of Indian imports will be lower as compared to those from the rest of the world, because of lower unit costs in India, as well as lower transportation costs (SBP, 2006, p 66).[13] Thirdly, it will have a beneficial impact on public finance as increased trade volumes will have a positive impact on customs revenues.[14] Moreover, if the proposed gas pipeline comes through, the estimated revenue impact is expected to be in the region of US $ 500-700 million annually (SBP, 2006, p67).

Similar benefits shall accrue to India as well, though their magnitude will not be as significant as for Pakistan simply due to the size and diversified structure of Indian exports.[15] Enhanced trade is also expected to expedite India's trade with central Asian countries, with the use of the land route via Pakistan.[16]

Further, in an era of increasingly open trade under the WTO regime, regional alliances serve to protect developing countries from the onslaught of developed countries' unfavourable terms of trade.

The negative impacts of opening up trade are few. Firstly, certain sectors – more in Pakistan than in India – will lose out in the short run. Some of these sectors, in any case, are not going to survive the onslaught of imports from other countries, particularly from China. Secondly, one feature of regional trade is that much of it takes place at an intra-sectoral level.[17] Over time therefore, apart from a few industries,[18] most will adjust to the reality of intra-sectoral trade.

## 2. Why Do India and Pakistan Not Open up Trade Relations?

Inspite of the gains from trade to be made by both sides, a number of justifications are put forth by state functionaries as well as political and business groups in favour of maintaining the *status quo*, i.e., limited trade between the two countries. This section will attempt to critically scrutinize these propositions for their economic validity.

### *2.1 MFN Status to Pakistan But Low Levels of Trade from Pakistan to India Persist*

[13] Nabi and Nasim (2001, p p178-179) also argue that a number of goods that are smuggled or remain non-tradeables, such as *paans*, *banarsi saris*, Hindi music, etc. will become easily available and increase the consumer surplus.

[14] It may be argued that because of lower unit values and now because of lowering of tariffs under SAFTA, revenues may actually fall. However, this phenomenon will be offset by reduction in smuggling and the expansion in trade that opening up of trade will bring about.

[15] For instance, Indian truck, tractor and non-vehicular tyres are used extensively in Pakistan. In fact Pakistan is the largest market for Indian tyres in these categories if trade to Afghanistan and UAE is taken into account. Information provided by Automotive Tyres Manufacturers Association, New Delhi. Similarly, in certain forms of machinery, such as textile and pharmaceuticals, Indian manufacturers' volumes will increase sizeably.

[16] Interview with Shabnam Parekh, PHDCCI, New Delhi conducted in December, 2005.

[17] For instance, India appears to have a decisive advantage in the engineering goods industry. But some years ago, while this author was conducting another study, he came across agricultural machine vendors who had received orders for thresher parts from the Indian Punjab.

[18] On the Pakistani side, the iron and steel industry and vehicle assembly plants can be clear losers.

That the level of trade from Pakistan to India, although increasing, is still significantly low points to the fact that even after India having granted the MFN status to Pakistan, hurdles exist that inhibit Pakistani exports to India. Indian business groups invoked the argument that all India can do is to give Pakistan the MFN status. The representatives of FICCI went so far as to suggest that after getting the MFN status, "the onus is on Pakistan" to increase its exports to India. This proposition is indeed a valid one -- if Pakistan has been granted MFN status, why does it not increase its exports to India ?

Pakistan's businessmen and state functionaries claim that the reasons for slow growth of Pakistani exports to India are two-fold. The first and more important reason is that India's tariff and non-tariff barriers are an impediment in the access to Indian markets. Second, it appears that high transaction costs also inhibit Pakistani entrepreneurs from investing in marketing their products to India.

Although average import tariffs in India have reduced substantially since the economy was liberalized in the early 1990s,[19] according to SBP (2006), agricultural tariffs continue to remain high.[20] Even if one concedes that there are impediments to the access to Indian markets for agricultural products due to high tariff barriers, this argument does not hold true for non-agricultural products. India has consistently reduced tariff barriers in accordance with WTO provisions for manufactures and semi-manufactures, and it is as difficult (or easy) for Pakistan to gain access to Indian markets as it is for other markets. Even for agricultural products, higher tariffs are compensated for by lower transportation costs and quicker delivery time, particularly in the case of perishable items.[21]

The existence of non-tariff barriers is a far more credible reason for the low levels of trade between the two countries. According to Pakistani as well as Indian observers, non-tariff barriers from the Indian side are a significant hurdle for Pakistan's exports to India. Non-tariff barriers take on different forms. One category is stringent rules-based non-tariff barriers. For instance, sanitary and phyto-sanitary requirements in India are considered to be exceptionally stringent by the exporters of agricultural, fisheries and livestock products from Pakistan (SBP, 2006, p. 22). These barriers are said to inhibit processed food exports from Pakistan, a commodity for which there is considerable potential. Similar quality certifications are required for other products too, as was recently required for cement exports to India.[22]

The other form that non-tariff barriers take is routine bureaucratic red tape. According to one Pakistani exporter, the proforma was 200 pages long and "considering the contents of the pro-forma it would have been very difficult for any Pakistani exporter to export the

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[19] Indian import tariffs reduced from 128% in 1991-92 to 34% in 1997-98. (SBP, 2006).

[20] In 2003, average agricultural tariff was 40.1%, while average non-agricultural tariff was 19.7%. (SBP, 2006, p. 18-19)

[21] However, complexities in duty and tariff structures still impede trade growth between the two countries. As an example, Indian economists have pointed out that "[i]mport duty on fabric in India is 10 per cent or a certain fixed amount per kg whichever is higher. Import duty on fabric in Pakistan is 25 per cent. However, the minimum per kg duty on fabric fixed by India is more than the 25 per cent duty on fabric imposed by Pakistan*."* Ahmad, Mansoor (*The News*, 13 March,2008). This duty structure is deemed to restrict Pakistan's fabric exports to India.

[22] Ahmad Mushfiq (*Daily Times*, 23 August, 2007)

commodity to India."[23] Regulatory certifications provide the bureaucracy with the leverage to discriminate between products and countries. Although in principle these regulations are applicable to all countries, Pakistani exporters claim that they have often been subjected to arbitrary discrimination based on the regulatory structure.[24]

Pakistani exporters and their representatives cite a number of instances where Indian customs created inordinate delays in clearing goods, [25] or where the railways have not facilitated the timely delivery of goods.[26]

Apart from reasons associated with regulation and bureaucratic inertia, high transaction costs also become barriers to trade. The stringent visa regime on both sides is cited as an important reason for low levels of official Pakistani exports to India in particular and bilateral trade in general. At the root of this barrier perhaps is the nature of political relations between the two countries. The private sector faces long-term uncertainty under such a scenario, making it difficult to take decisions related to investments in relationships and infrastructure – such as opening offices in the other country and employing its nationals for sales and marketing. Similarly, the large infrastructure of informal trade also acts as a trade barrier. Traders have invested in third country routes, have set up offices in those countries and have invested in networks for customs clearance to overcome the issue of rules of origin problems that arise.[27] Unless greater certainty in the broader political environment is achieved, the problem of long-term trade commitments will remain.

While individual Pakistani exporters (and Indian importers) are justified in invoking problems associated with the trade regime for not enhancing their trade with India, it is possible for business associations (and other collective fora) and policy makers to resolve these issues. First of all, WTO rules provide for resolving some of these issues. Other issues can be resolved bilaterally. It is a routine function of commerce and trade ministries all over the world to bilaterally resolve such issues with their counterparts.

### *2.2. Protectionism and the Kashmir Dispute: Pakistani Positions on Restricted Trade with India*

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[23] Joint statement: Lahore Chamber of Commerce and Industry (LCCI) President, Shahid Hassan Sheikh, Senior Vice President, Yaqoob Tahir Izhar and Vice President, Mubasher Sheikh. *Daily Times* (2007), 'Non-tariff barriers hampering Indo-Pak bilateral trade: Indian commerce ministry issues pro-forma to cement exporters', 26 September.

[24] Opening of bank LCs also poses a trade barrier: "due to the non-availability of representatives of local banks from either country in the other, LC opening is another major problem, since India allows opening of LCs only in the banks recognized by the Indian government." (SBP, 2006, p. 21)

[25] This was according to Saifuddin Khan, general manager of marketing at Lucky Cements, one of Pakistan's largest cement companies. He said that initially "Indian buyers were very cautious" in importing cement from Pakistan. "They were giving orders for 200 tonnes, so that they could check out the duty structure and figure out how to get the supply out of customs," referring to both the complexity of duty regime in itself and possible customs clearance issues. Daily *Awaz* (2008).

[26] In one case of molasses exports from Pakistan to India, the Indian Railways did not change the track gauges on their side of the Wagah Border in time for the perishable commodity to be transported. (Interview with Indian Businessman, December 2005, Delhi).

[27] The author was told that a number of Pakistani tyre importers from India have set up shop in Dubai where they import tyres from India and then re-export them to Pakistan. This was further confirmed by the All India Tyre Manufacturers Association (ATMA) also.

The issue of protectionism in trade with India is often raised by sections of the business community as well as by those towards the right of the political spectrum in Pakistan. It is alleged that industries such as steel, light engineering, the auto industry and pharmaceuticals will be adversely affected. Such pronouncements do not appear too credible, particularly when made by a country that has signed up to the WTO and has an open trade regime with the rest of the world.[28]

Finally, the real stumbling block in India-Pakistan trade is the fact that Pakistan has not granted MFN status to India. The 'official' position from the Pakistani side that is repeated *ad nauseum* is that unless the Kashmir dispute is resolved, Pakistan will not normalize trade relations with India.[29] Underlying this position is the apprehension that trade links with India will create a level of economic interdependence between the two countries and has the potential of creating a 'vested interest' in the business community and consumers of Indian commodities that will dilute the 'urgency' of the Kashmir issue.

Although the logical conclusion of this 'official' Pakistani position is never spelt out by its proponents, it can only mean that normal trade relations between the two countries, it is feared, will preclude the possibility of escalated military conflict. Even if one takes a less stark view, economic and commercial relations can dilute a 'Cold War-like' situation, manifested in high levels of military expenditure. Regardless of where Pakistanis stand on the centrality or otherwise of the Kashmir dispute vis-à-vis its relations with India, it is not necessary that political disputes will be swept under the rug at the altar of economic expediency. China's long-lasting territorial disputes with Taiwan and Japan have not been diluted because of economic relations.

The subservience of trade and the economic well being of the populace to political and territorial disputes may have been an idea in vogue during the Cold War, but in the twenty-first century it will be increasingly difficult for Pakistan to sustain this position in state policy (see Sridharan, 2005). Moreover, by liberalizing its economy, Pakistan has also acknowledged that it values trade as an important cornerstone of its economic policy. Trade discrimination against India, regardless of territorial and political disputes, is thus inconsistent and untenable.

## 3. Structural Explanation for Restricted Trade between India and Pakistan

If there are gains to be made from trade, and problems in the way of an open trade regime that are not entirely unsurmountable, the question that arises is -- why do India and Pakistan not trade freely? With two of its largest entities not developing full trade relations, the South Asian region remains the only geographically contiguous region in

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[28] One Pakistani businessman told us, "If this was the case, then Pakistan should not be trading with the US or Germany or indeed with China. If we have managed to keep our industry intact while trading with them, trading with India is not about to effect further damage to our industry." (Anonymous, on respondent's request).

[29] For instance, Shaukat Aziz, the Prime Minister of Pakistan from 2004-07, was reported to have "underlined the need for resolution of the Jammu and Kashmir dispute to create prerequisite political framework conducive to closer economic cooperation between Pakistan and India. Daily *Awaz* (2008).

the world today that is yet to develop a fully functional and effective regional trading bloc.[30]

While regional trading blocs are the norm today, they are not historically unique. Most of these arrangements emerged after the Second World War, and many of them emerged at the end of the Cold War. Prioritizing trade, and by doing so, prioritizing the welfare of its own people over territorial and political disputes, is thus a relatively new phenomenon.

The next section will assess the structure of states that were successful in establishing full trade relations with political adversaries, and compare them to the structure of the state in India and Pakistan. A corollary to the structure of the states is the dynamics of state-business relations. It is important to explore this dynamic to determine the extent to which the private sector in either country can push for opening up of trade in a situation where – as discussed earlier – businesses stand to gain from trade.

### *3.1. A Typology of Structural Characteristics of State Types*

As a broad brush characterisation,[31] two structural characteristics are discernible as far as state-society relations between countries that have made a transition to prioritizing economic well-being over military conflict are concerned. The first is the European and North American model, in which core interests of the bourgeoisie take precedence over and above those of other groups and classes.[32] The second category is of those countries – mainly in East and South East Asia -- where the state has been termed as 'developmental.' According to Evans (1995, p 249), a developmental state is one where the state is autonomous of "politically powerful constituents." However, Evans goes on to argue that this autonomy is embedded "in a dense network of ties that bind groups and classes that can become allies in the pursuit of societal goals."[33] In both these state types, therefore, either the interests of the bourgeoisie or the 'national interest,' as defined by the developmental state, have played an important role over time in giving precedence to economic growth and welfare, of which trade in general and regional trade in particular is an important component.

Arguably, the state in South Asia has different antecedents. The structure and character of the state continues to bear deep imprints of the colonial mode of governance. According to Jalal (1995), the non-elected arms of the state remain ascendant over the elected arms of the state, thus precluding substantive democracy in the region. These non-elected arms – the bureaucracy, the military and the judiciary – in this scheme are seen to be

[30] Virtually all other regions have developed trading blocs and regional trade is a large part of individual countries' overall trade profile. The European Union (EU) is the largest and the most robust of such blocs. ASEAN in South East Asia, NAFTA in North America, MERCOSUR in South America and the African Union in Africa cover most of the contiguous regions on the globe.

[31] This characterisation of the state abstracts from the rich and varied debate on the 'state' in the literature and is merely employing some convenient typologies to demonstrate differences in state types.

[32] This does not mean that other classes or groups do not matter in this scheme. Developed capitalist countries are characterized by a political settlement of progressive taxation, which enables other groups and classes to enjoy benefits in terms of the provision of public goods and welfare transfers. Surpluses generated from capitalist enterprise are inextricably linked to the welfare of society as a whole.

[33] Another characteristic of the 'developmental state' is the creation of effective state capacity through an institutionalized bureaucracy. See (Evans, 1995) for further details.

'overdeveloped' with respect to the rest of society (Alavi 1998). Alavi characterizes the state in South Asia as 'relatively autonomous' from dominant groups and classes in society whereby none of these groups are deemed strong enough to dominate the state.[34]

In the Pakistani context, the bureaucratic-military oligarchy has remained ascendant in the absence of formal democracy in the country for the better part of its existence. In fact, over time, a shift from the oligarchic rule of the bureaucracy and the military to one of military hegemony is discernible.[35]

The interests of the military preclude prioritizing trade relations over territorial disputes. According to Gazdar (2006), any process which normalizes relations between the two countries "would undermine the political legitimacy of the military as an entity, consequently giving rise to challenges to its claims on the country's economic resources."

More important, however, is the political and ideological role of the Pakistani military. Haqqani (2005) shows that since the imposition of martial law by Yahya Khan (1969-71), religious groups have provided support to subsequent military dictatorships in Pakistan. This collusion between the military and religious parties is predicated on an ideological affinity, especially in their anti-India posture. Added to this ideological congruence is the structural dependence of the military on the militant arms of the right-wing parties. Since the Pakistani military embarked on a strategy of covert warfare in Afghanistan and Kashmir, the dependence of the military on such militant groups to execute covert warfare has added another dimension to this collusive relationship.[36]

In India, on the other hand, formal democracy has acquired deep roots and mediated the interests of society with the non-elected elements of the state to a much greater degree than in Pakistan. Bardhan (1984 and 2000) contends that amongst the dominant proprietary classes – the capitalists, the traders, the bureaucracy, the rich peasantry and educated middle classes – none are powerful enough to dominate the state. Bardhan (2000) further contends that the intermediate classes and the rich peasantry have managed to acquire a large chunk of public resources in the form of state subsidies.[37] The size and diversity of interest groups and class divisions have meant that collective action is difficult to forge, which consequently sustains the relative autonomy of the state.

The above discussion on the structural characteristics of states as an explanation for the lack of prioritization of trade relations over politico-military concerns is admittedly a static approach. After all, both countries have liberalized their economies over the last

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[34] The term 'relative autonomy' implies that the state has degrees of autonomy from society and from the rest of the world. This should be conceptualized on a continuum rather than at discrete points in time.

[35] The bureaucracy as an institution has weakened overtime. The process started in 1973 when the first Bhutto government removed constitutional protections prevalent earlier. Subsequently, successive martial law governments have further weakened the corporate structure of the civil bureaucracy. See Sayeed and Cheema (2006) for further details.

[36] Since 9/11, the contours of Pakistan's covert warfare strategy have been the subject of intense journalistic and academic scrutiny. See for instance, Haqqani (2005), Abbas (2005), Hussain (2007) and Grare (2007). The evidence produced and the conclusions reached in this literature all point to collusion between the religious right wing and the military in conducting covert warfare.

[37] It has been estimated by Mundle and Rao (1991) that total government subsidies in 1987-88 amounted to Indian Rupees 42,324 crores, representing 15% of GNP that year. Bardhan (2000, p 343 ).

two decades. As a result, the growth of the private sector in general and big business in particular has been facilitated by both states. In this milieu of private sector-led growth, therefore, can it be assumed that the relative power of big business vis-à-vis other contending groups and classes in society has not improved to the extent that its interests and growth prospects are adequately protected by state policy? We address this issue below.

### *3.2. State-Business Relations and Regional Trade*

The role of the private sector in both economies has increased overwhelmingly since the liberalisation of the economies of India and Pakistan. The Indian economy has demonstrated consistently high growth rates over the last fifteen years, and Pakistan's economy has also witnessed growth, albeit less consistently than in India. To what extent has this increased the leverage that big business has with the state in the two countries? In other words, have the states in India and Pakistan transformed over time where big business is able to significantly influence the overall drift of state policy? By tracking the historical evolution of state-business relations in both countries, we attempt an answer to the above question.

#### *3.2.1. The 'Political Economy of Defence': State-Business Relations in Pakistan*

Big business in Pakistan has historically tended to collude with military governments. This collusion was ideologically driven during the Cold War: the military shielded the private sector and big business from left wing politicians and in turn, big business provided the requisite political support to the military. In order to generate growth and revenues for the state, military governments formulated business-friendly policies, with ample opportunities for businesses to seek rents.

This collusive relationship of the Cold War era, however, did not mean that there was any form of 'business capture of the state', as suggested otherwise.[38] Kochanek (1983, pp 242) argues that although under Ayub Khan's (1958-69) dictatorship, big business was facilitated by the state and its representatives were nominated in an advisory capacity on a number of policy-making fora, "the government retained the absolute right" to determine policy.[39]

After a brief hiatus during the populist regime of Bhutto (1971-77), big business again resumed its collusive relationship with the Ziaul Haq military regime (1977-88). While the terms of engagement were similar to those in the Ayub days, Zia further eroded the possibility of collective action amongst business groups by ethnicizing business fora (Kochanek, 1994).[40] By the time the Musharraf (1999-2008) came to power, the military had emerged as an entrenched corporate entity. Siddiqa (2007) has documented

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[38] Amjad (1982) has made this argument which had gained much currency in the late 1960s and the 1970s.
[39] For further details on the government retaining exclusive control over policy-making in the Ayub period, see Kochanek (1983, pp 240-49).
[40] Kochanek describes the manner in which the Zia regime created a wedge between the Punjabi and Urdu/Gujarati speaking businessmen, both in the Federal as well as Karachi Chambers of Commerce.

significant interests of the military in manufacturing, construction, communications and financial services that have been further consolidated during the dictatorship.[41]

Although the period of Musharraf's rule spelt prosperity for big business in Pakistan, both due to pro-business policies as well as excess liquidity in the market after 9/11, the hegemonic control of the military has not altered. This is best gauged from the fact that although military capital has been steadily encroaching upon the territory of big business,[42] but rather than resisting it, the latter has settled for a smaller market share by colluding with it.

With regard to India-Pakistan trade, there is a perceptible change in the big business fora in Pakistan. Through the 1990s, a few voices emerged from within the big business community in support of opening up trade with India. The most prominent development in this regard was the publication of a report by the Karachi Chamber of Commerce and Industry (KCCI) that advocated granting India the MFN status, particularly after Pakistan had liberalized its regime and signed up to WTO (KCCI, 1996). By the mid-2000s, interaction between business groups in India and Pakistan increased manifold. Eulogizing the benefits of trade with each other has become part of the discourse of the business fora in both the countries. Improvement of bilateral political relations since the Musharraf-Vajpayee summit in January 2004 has paved the way for this increased interaction amongst the business communities. This reflects the fact that business fora also activate their lobbying once the security and geo-political environment becomes favourable.

Pakistan's big business has become more influential to the extent that it will be difficult, if not impossible, for any government – whether military or civil – to reverse the basic precepts of liberalization. But with regard to trade with India, the military hegemonic state is still powerful enough to ride roughshod over all interest groups and classes that threaten its interests.

### *3.2.2. State-Business Relations in Democratic India*

State-business relations in India differ from those in Pakistan in several ways. First, India's growth over the last two decades has been more sustained than in Pakistan. Second, Pakistan's economy has always been relatively more open than India's up until the early 1990s. As a result, India had an entrenched group of protectionist businesses which had developed over a long period of time.[43] Third and most importantly, state-

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[41] It may be argued that since the military is in the business of conducting business, the gains from trade with India that accrue will benefit military enterprises also. While this may be a possibility in the distant future, in the short or medium term this appears unlikely for two reasons. First, military capital is primarily involved in producing 'non-tradeable' goods and services. Second, military capital is not bound by efficiency criteria that apply to private sector enterprises as it faces a 'soft budget constraint' – as the state consistently picks up its bills when military enterprises make losses (see Siddiqa, 2007 and Sayeed, 2007 for elaboration of this argument).

[42] For details, see Siddiqa (2007).

[43] Links of individual businessmen with the Indian National Congress date back to the 1920s (see Tripathi, 2004). Both collectively and individually the leading lights of Indian businessmen forged close relationships with the Congress leadership (see Tripathi, op.cit, Piramal 1996 and Lala, 1993)). Though they could not prevent the Congress leadership from adopting a largely public sector led growth model, the protective trade regime went largely in their favour.

society relations in general and state-business relations in particular are mediated through the democratic process in India.

India's growth trajectory is generally traced from 1991, when the Congress government liberalized the economy. Kohli (2006), however, traces a 'paradigm shift' in state-business relations starting in 1980 when Indira Gandhi took over power. It is then that she moved away from '*garibi hatao*' as the focus of her socio-economic agenda towards an agenda based on improving the productive base of the economy. While this policy shift did enhance the influence of big business vis-à-vis other important groups in India, it was clearly a state-led initiative.

Over time, according to Sinha (2005), India's big business fora - Federation of Indian Chambers of Commerce and Industry (FICCI) and Association of Chambers of Commerce (ASSOCHAM) – benefiting from reduced red tape and protection provided to them -- resisted further economic liberalization that would result in opening up the Indian economy to foreign trade. But Rajiv Gandhi attempted to dilute the influence of FICCI and ASSOCHAM by promoting the Association of Indian Engineering Industry (AIEI) which later came to be called the Confederation of Indian Industry (CII), and became the countervailing forum to the entrenched business groups advocating a more liberalized trade regime (Sinha, 2005).[44] The emergence of AIEI/ CII, to create an effective countervailing force happened because the state exhibited a degree of autonomy vis-à-vis business groups which allowed the leadership to undertake such a move. Moreover, the openings within the federal and democratic structure allowed AIEI / CII to interact with and provide services to various state governments that reinforced their political influence.

The post 1991 reforms have also been sustained by the state balancing the demands of different interest groups while retaining the levers of policy-making in its hand. According to Kohli (2006), the initial leverage was gained by the state under the guise of policy conditionalities imposed by the IMF. While sustaining the reforms was not a smooth process,[45] the lack of collective action amongst business interests as well as negotiations through the political process amongst different protagonists resulted in essential elements of reforms enjoying bi-partisan consensus (See Sridharan, 2004).

Broadening the scope to Bardhan's framework, how are non-business proprietary groups in society placed in the era of economic liberalization and growth? Did the relative power of the rich peasantry, the bureaucracy and the intermediate classes wane with the advent of sustained private sector led growth since 1991? Jenkins (1999) argues that far from being irrelevant, the political process played a catalytic role in business groups forging alliances with other interests in society through patronage networks. Whether business groups have strengthened their position vis-à-vis other groups over the last two decades is a moot point for our purposes[46]; what is important is that other proprietary classes are

[44] Jenkins (1999, p 113) argues that this did not mean that the protectionist lobby lost its influence entirely. Instead they changed their demands from protection to a "more selective integration with the global economy."

[45] See Jenkins, (1999) and Sinha, (2005) for further details.

[46] It is important to recall that unlike Pakistan, restricted regional trade is less economically problematic for India. It will be a different matter if state policy flew in the face of the core interests of India's economic

relevant enough to enable the state to maintain a degree of relative autonomy from all groups and classes.

The analysis in this section suggests that while state-society relations are fairly different in India and in Pakistan, neither country has transformed in the direction of developmental states in a manner similar to the East Asian states, nor are they bourgeoisie-dominated like the OECD countries. The paper also argued that state-society relations in both India and Pakistan have not structurally altered in spite of liberalization and private-sector led growth in both countries.

**Conclusion**

This paper has sought to argue that considering the manner in which state-society and state-business relations are structured in India and Pakistan, the state will have to normalise trade relations relatively autonomously.

The weight of economic compulsions and changing geo-political configurations – where the US has an interest in Pakistan and India burying the hatchet – will sooner or later compel the states to remove existing bottlenecks in their trade relations. Moreover, given the drift of globalisation, the emerging global economic crises, and Pakistan's need for foreign capital to boost investment and tide over its perennial balance of payments problems has increased the probability of capital flows between the two countries.

Since the onus of normalising bilateral trade and economic relations is on Pakistan to a greater degree, there are encouraging signs so far as the present political configuration in the country is concerned. The dominant political parties in Pakistan – the Pakistan People's Party and the Pakistan Muslim League (N) – have both favoured improved economic relations with India. This is an opportune moment, also because the Pakistani military is on a weak political footing and fighting battles against Islamic extremists.

This paper has also attempted to demonstrate that since there are gains from trade for both countries, it is important that healthy economic relations between the two countries be treated as an end in itself. The tendency by both liberals as well as conservatives to invoke the debate on trade to either promote the cause of peace between the two countries or raise fears about ideological or territorial issues being pushed back, has tended to obfuscate what is essentially an economic debate.

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growth if it did not trade with Pakistan to precisely gauge the actual influence of big business on state policy.

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