Most Favored Nation (MFN) Treatment for India An Analysis

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Abstract

[While MFN treatment is one of the basic principles of the multilateral trading system under GATT/WTO, exceptions are there and have been exercised by countries considering their own objectives and interests. While India granted Pakistan MFN status since 1996, trade balance remains heavily in favor of India due to Non-Tariff Barriers (NTBs) imposed by India. Considering the nature of relationship between the two countries and state of affairs of Pakistani economy, MFN status will have some worth pondering pitfalls for Pakistan, and only meager gains are expected. Moreover, the hasty decision to grant MFN status to India seems driven more by international agenda than any indigenous imperative. Pakistan needs to adopt a gradual approach and should go for complete liberalization of trade only after guarantees for removal of NTBs and its rightful share of water. – *Author*.]

Introduction

The issue of granting Most Favored Nation (MFN) treatment to India has generated heated debate with a variety of strong arguments for and against the decision. As the federal cabinet announced in November 2011 that it had decided 'in principle' to reciprocate the Indian decision of granting MFN treatment to Pakistan (in 1996), not only a countrywide debate ensued but protests also erupted in parts of the country to oppose the decision.

The proponents argue that there is no harm in granting the MFN treatment, as both Pakistan and India are already members of South Asia Free Trade Agreement (SAFTA), which can be termed as an MFN-plus arrangement. Those opposing the move are of the view that it will increase the influx of Indian goods to Pakistan, and Pakistani industry will be at the receiving end. A very strong opposition to any liberalization of trade with India on the political grounds also remains there, separately.

Implications, positive or negative, apart; it would not be wrong to say that the issue is rather misunderstood at public and even academic levels. This paper briefly introduces the concept of MFN treatment, sheds some light on the recent developments taking place in Pakistan India context; explores its bearings for Pakistan and suggests an approach for the Pakistani decision makers. Pakistan India trade is a broad subject and inevitably has a political angle attached to it, which

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cannot be ignored in any discourse. This paper, however, approaches only the recent decision of the incumbent government in Pakistan to liberalize trade with India fully by end 2012, by granting MFN treatment from start of January 2013. The write-up however traces, in brief, the international pressures on Pakistan in this connection – highlighting the decision more as an instrument of international agenda than the indigenous one.

What is Most Favored Nation (MFN)?

Most Favored Nation (MFN) treatment is the basic principle and one of the general provisions and obligations of General Agreement on Tariffs and Trade (GATT) and World Trade Organization (WTO). The general principle of this provision is that a member state of the GATT/WTO, will accord the MFN treatment to all other member countries, and will adopt no discrimination against any other. Thus, every other member state of GATT/WTO will be the "most favored nation" on equal, non-discriminatory ground. In trade terms, it means that rates paid by a country declared as MFN on its exports to the markets of the country granting MFN, will also be applicable for the other countries and in this way, all countries will be treated equally as MFN.[1]

Article I of the GATT provides that the member states will accord the MFN treatment to all other member countries and therefore basically lays the rule-principle of nondiscrimination amongst the WTO members with respect to:

- Customs duties and charges of any kind imposed on or in connection with importation or exportation or imposed on the international transfer of payments for imports or exports;
- The method of levying such duties and charges;
- All rules and formalities in connection with importation and exportation, and
- Advantage, favor, privilege or immunity granted to a WTO Member to any product originating in or destined for any other country and has to be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties.[2]

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[1] Das, *WTO and the Multilateral Trading System: Past, Present and Future.*
[2] For a detailed reading of WTO/GATT agreements, please see WTO, "The Results of Uruguay Round of Multilateral Trade Negotiations."

Exceptions to MFN

However, the above provisions do not mean that extending MFN treatment to all the member countries is mandatory. GATT, the agreement in operation since January 01, 1948, which transformed into WTO from January 1, 1995 (also known as GATT 1994, as the same agreement was continued with some amendments and several additions) provide certain exception to this general principle. These exceptions include:

- When two or more member countries enter into a 'Free-Trade Area' or 'Customs Union' between themselves, they are not required to necessarily accord the equivalent tariff treatment to the members outside such arrangements (Article XXIV of GATT 1994
- When the member countries accord some trade benefits to another member country with an aim to facilitate frontier traffic (XXIV.3)
- Besides, MFN treatment does not apply to Government Procurement and can also be denied, citing the security reasons (Article XXI).

It means there are still 'reasons' citing which a country can block or deny MFN treatment to other. Besides the exception mentioned above, there is a special exception provided in GATT specifically for Pakistan and India. Paragraph 11 of GATT Article XXIV reads as follows:

> "Taking into account the exceptional circumstances arising out of the establishment of India and Pakistan as independent States and recognizing the fact that they have long constituted an economic unit, the contracting parties agree that the provisions of this Agreement shall not prevent the two countries from entering into special arrangements with respect to the trade between them, pending the establishment of their mutual trade relations on a definitive basis."

This particular exception literally provides the two countries with an exception to enter into a specific arrangement for mutual trade "pending the establishment of their mutual trade relations on a definitive basis." However, this 'exception' is seen by some as more of a 'positive' exception than the prohibitive one, as it implied that the two countries, arising out of a single economic unit, were allowed to go for an arrangement beyond general principle of MFN, not denying it.

It may be noted here that Pakistan does not stand out as the only example of exercising an exception and not granting the MFN. The United States has been using the granting of MFN as a tool to achieve its political or economic objectives in case of various countries including

China for years.[3] Hennery Kissinger (2011) in his recent book *On China* also details how politics has been prevailing over grant of MFN treatment to China by the United States, not very long ago.[4]

The Pakistan-India Case

Since independence in 1947, Pakistan India trade has been conducted on the basis of a host of bilateral, regional and multilateral arrangements. Commercial relations, however, were blocked between 1965 and 1974, owing to two wars between the two countries. Trade resumed in 1974, and remained at negligible levels for the next two decades that followed.

India had granted Pakistan the MFN treatment in 1995, soon after the WTO was formed, and the treatment is in force since 1996. However, Pakistan had not reciprocated so far, citing that despite giving Pakistan MFN treatment, India maintained a number of non-tariff barriers (NTBs) against imports from Pakistan. These NTBs include requirement of political/security clearance, sampling/customs inspection, requirements of technical/standard certification, labeling and marketing rules, packaging rules and specifications etc.[5]

Therefore, despite the grant of MFN treatment, Pakistan suffers a heavy trade deficit with India, which is continuously increasing as well. According to State Bank of Pakistan's statistics, with imports payment of $1.033 billion and export receipts of $313.037 million, Pakistan faced a deficit of $719.857 million in fiscal year 2008-09 with India. The deficit in the next fiscal year 2009-10 surged to $802 million, up by 11 percent, with $1.061 billion imports payment and $260 million export receipts. The balance further deteriorated during the last fiscal year as Pakistan faced a deficit of $1.158 billion as compared to $802 million in fiscal year 2010, depicting an increase of 44 percent in fiscal year 2011.[6]

Pakistan, though did not grant MFN treatment to India, has been maintaining a 'positive list' of importable items from India, which it has been continuously increasing. The list started with seven items when the trade was started again after a gap of 9 years in 1974, had reached 800 items in 1996 when India granted MFN treatment to Pakistan and had risen to 1945 items by the end of 2011 when Pakistani government moved forward towards granting India the MFN treatment.

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[3] Qamar, "Trade between India and Pakistan."
[4] Kissinger, *On China*.
[5] *Op. Cit.* Qamar.
[6] *Business Recorder*, February 15, 2012.

Recent Developments

It was in November 2011 that Pakistani government announced that it has decided 'in principle' to give India the much awaited treatment. While there may have been some maneuvering behind the scenes, the public decision was so quick, apparently, that it surprised even the Indian officials, if the media reports are to be believed.[7] There prevailed a confusion in Pakistan over what actually will be the *modus operandi* of grant of this treatment, as much as this confusion is present in the not so clear interpretation of WTO/GATT documents that how this treatment is accorded, is it automatic or whether it has to be notified.

However, on February 29, Pakistani cabinet decided that the 'positive list' of importable from India will be replaced with a 'negative list' of 1209 item, in which trade will be restricted, implying that trade will immediately be opened for all of the items not listed in the 'negative list'. Surprisingly, in the same session, the cabinet decided that even this 'negative list' will be removed fully, in phases, by December 31, 2012 and thus, trade with India will be on the basis of MFN treatment from January 01, 2013.[8]

The premise and the situation on ground

It was argued that as SAFTA already provides for a 'sensitive list' for the member countries, there will be no harm in granting the MFN treatment and removing the 'positive list', believing that 'sensitive list' will serve the purpose of restricting and undesired influx of imports from India that may be damaging for the local industry. However, ironically, the 6th ministerial meeting of SAFTA, held in Islamabad on February 15, also announced that member countries have agreed to continue reducing their respective 'negative lists' further with an aim to enhance regional trade.[9]

Another argument forwarded by Pakistani officials and picked up by the proponents of free trade between India and Pakistan was that in exchange for MFN treatment, India may be asked to remove NTBs against Pakistani exports. Thus, it was argued, Pakistani exports will also increase. Rather, Pakistan will gain more as Indian market of 1.2 billion people was much larger than Pakistani market of 180 million people. However, there has been no assurance or guarantee on part of India in this regard, despite the claims of Pakistani officials.

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[7] Malik, Mehreen Zehra. "India Surprised over Pak Move on MFN Status," *The News International*, November 16, 2011.
[8] *The Nation*, March 01, 2012.
[9] Khan, Mubarak Zeb. "S. Asian Nations Agree to Reduce Sensitive Lists," *Dawn*, February 17, 2012.

The evident reality is that even if India removes all or some of the NTBs on Pakistani exports, Pakistani industry at present is not in a position to benefit owing to the severe gas and electricity shortages and the damages caused to Pakistani economy by floods in 2010 and 2011, as well as the negative impacts of the decade long 'war on terror'. Thus, timing of the decision is also questionable.

International Dimension – agenda beyond bilateral trade

The decision by Pakistani government comes in a peculiar environment at global and regional level, when India visibly is being promoted as 'emerging power' apparently to contain China's rise in Asia. Hillary Clinton's speech in Chennai during her visit to India in July 2011 made waves all over the world in which she publically invited India to come forward and assume the leadership role in Asia Pacific region.

There is no denying the fact that Pakistan has been under visible pressure to 'normalize' its relations with India, including opening of trade and providing transit to Indian goods and services, towards Afghanistan and Central Asian Republics (CARs). First, the country was cajoled into providing transit facility to India under Afghanistan-Pakistan Transit Trade Agreement (APTTA) that was signed in Washington in 2009. Hillary Clinton, in one of her interviews to a Pakistani journalist in October 2011, expressed her desire in the following words:

> "We share a vision of a sovereign, self-sufficient and democratic Pakistan; a Pakistan at peace and trading with its neighbors and full of opportunities for both men and women."[10]

The decision of grant of MFN treatment to India can also be linked with the much talked about New Silk Route Initiative of the United States of America, which also, apparently, seems to be an effort to provide India an unhindered access to Afghanistan and CARs. Pakistan is also under pressure to open more crossing points at the Line of Control (LoC) in Kashmir, for Cross LoC trade. All these moves seem to be in sync with each other, and make one assume that the decision to grant of MFN treatment to India has a lot to do with international agenda than just bilateral trade.

Implications for Pakistan

Granting MFN Treatment implies that while gains would be questionable, owing to India's NTBs and current fragile state of Pakistani economy, there are worth pondering consequences considering the peculiar nature of relationship between the two countries and state of affairs of their economies at present.

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[10] US Department of State, "Interview of Hillary Rodham Clinton by Moeed Pirzada of Pakistan TV."

Gains, perceived and actual: It is perceived, and as a general rule it is true to some extent, that enhanced trade leads to mutual gains and therefore the decision to grant MFN will have some positive results for Pakistan's commerce and industry in particular, and overall economy in general. Some of these perceived benefits, which this government and its functionaries describe as the merits of this decision are following:

- Opposition to MFN treatment for India is often based on misconception of the definition. It is wrongly believed that giving MFN treatment to India will mean zero rated and free trade, meaning free flow of goods and services. This is not the case, and MFN treatment means uniform tariff rate and structure for all WTO member states.
- Pakistan and India are two close neighbors, and trading with each other will save time and transportation costs. While direct trade between the two countries is not very high, the two countries trade via third markets (mostly Dubai, Sri Lanka and Hong Kong) in a higher volume, which certainly increases time and intermediary costs. These costs can be saved.
- Geographic nearness, long border and lack of desired level of legal trade transactions results in illegal trade i.e. smuggling. Legalizing this illegal trade will result in enhanced revenues for both the countries, particularly Pakistan.
- It would be beneficial for Pakistan to import the same items from India that it exports from the Western and other far away countries. Less costly items will be available for Pakistani consumers, and this will be in 'consumer interest'.
- Cheap raw materials will be available for Pakistani industries which can reach Pakistan in a relatively quick span of time.
- Diplomatically, it is believed that Pakistan will be able to generate goodwill in India and globally as well. This decision will also result as a Confidence Building Measure (CBM) between the two countries.

The other side of the coin: The above mentioned 'perceived gains' present just one side of the coin. As is the case with every decision, the treatment will entail important pitfalls. There are some other considerations to be taken into account, for instance:

- There are many studies indicating that as compared to Pakistani manufacturing sector, Indian industry is much more broad-based, subsidized and more competitive. This is because of easy and cheap availability of power and credit as against Pakistan's industry operating in an environment of high cost of doing business and severe power shortages. MFN in these circumstances will mean that Pakistan's already struggling industry will be wiped out.
- India's NTBs and tariff rate quotas will continue to hinder Pakistan export potential, trade deficit with India will continue to rise.

- Considering the nature of relationship between Pakistan and India, in which trade has been cut off many a time in the past due to hostilities and tensions, and considering the substantial issues between the countries are still unresolved, Pakistani industry and economy cannot afford to build any sort of dependence on supply of raw materials, even though the cost of import from other countries is relatively heavy. It must not be forgotten that India has opted out of proposed Iran-Pakistan-India gas pipeline because it does not want its industry/economy to depend on gas supplied through Pakistan.
- Allowing inflow of cheaper goods only in the name of 'consumer interest' is not always advisable. A country will always have to find a balance between becoming a trading country and a manufacturing/industrial country.
- The biggest demerit, which is being neglected in prevailing discourse on the subject, is that MFN does not merely mean an abolition of 'negative list' of tradable items from January 1, 2013. MFN also implies that Pakistan will have to allow free transit of Indian goods, services and their transportation through Pakistani territory towards other countries.[11] Soon after Pakistani announcement to grant the MFN treatment, Indians traders have already started asking for transit access to Afghanistan and CARs. Chairman Confederation of Indian Industry Amritsar Zone, Suneet Kochhar, has demanded that "now Pakistan must act on giving transit route to India for catering to Central Asia."[12]

  It is well known that most of the transit goods destined for Afghanistan, mostly subsidized, have been ending up in Pakistani market, severely damaging the local industry. This will be a major drawback in this arrangement. While Pakistan may get some transit fees, past experience of transit trade tells that most of the goods destined for Afghanistan are dumped in Pakistani market. Furthermore, if it so happens, Pakistan's weak physical infrastructure, particularly the roads network that is already in shambles due to excessive use by containers carrying NATO supplies, cannot afford the unprecedented load of traffic from India to Afghanistan and Central Asian Republics.
- Allowing inflow of cheaper goods in the name of 'consumer interest' is not always advisable. A country will always have to find a balance between becoming a trading country and a manufacturing/industrial country.

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[11] Once para 11 of GATT article XXIV is removed, India will be entitled for unhindered transit through Pakistan based on full application of "the agreement" (GATT) as well as the possible interpretation by India of the words "advantage, favor, privilege or immunity granted to a WTO Member to any product originating in or destined for any other country" in article I on GATT.

[12] *The News International*, March 3, 2012.

- Trade, as the record shows, has not been able to build trust between Pakistan and India as the reasons of mistrust are deep-rooted in strategic issues. It is not simply a case of 'trading for peace' but essentially demands sustainable 'peace for trade'. Also, the conduct trade between countries of the world in present times, including the world's two largest economies, United States and China; trade cannot be fully isolated from the political issues between the countries involved.

The Reactions

The reaction to the decision in Pakistan has been varied, motivated by the commercial interest of the businessmen involved. It is quite natural that pure importers and those industrialists whose industries would benefit from cheap raw materials or machinery would welcome the decision. So has been the case. However, some objective voices have also emerged. Chairman of All Pakistan Textile Mills Association (APTMA), Mohsin Aziz says that "textile industry had no apprehensions about granting of MFN status to India but would like to be assured of level playing field"[13] citing the continuity of India's NTBs. Pakistan Economy Watch, a Civil Society Organization based in Islamabad has cautioned that MFN status will be damaging for Pakistan's largest export earner, the textile sector.[14] Rice exporters, the second largest export sector of Pakistan, have also demanded that rice should not be traded with India on MFN basis.

The budding auto and pharmaceutical industries have also expressed their concerns. Some of the leading trading bodies including Rawalpindi Chamber of Commerce have opposed the decision. It needs no mention that business sectors and bodies may have their particular business interest in any such decision by the government. However, it is quite clear that all the stakeholders have not been duly consulted - particularly in case of 10 months time frame for abolition of the 'negative list". Vice President of federation of Pakistani Chambers of Commerce and Industry, Khalid Tawab is of the opinion that 10 months period is insufficient and government should have given at least three years to the local industry[15].

Conclusion and the Course Ahead

A closer look on the concept of MFN treatment shows that exceptions have existed, and have been exercised by countries for their own national interest. Based on the above discussion, one can conclude that in purely commercial terms there may be some short-term benefits of granting MFN treatment to India but those seem to be outweighing the

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[13] Rana, Ishfaq Parvaiz. "Divergent Reaction to 'Negative List'," Dawn, March 2, 2012.
[14] *The Nation*, December 5, 2011.
[15] Op. cit. Rana, Ishfaq Parvaiz.

costs and demerits. Thus, this decision may result to be a heavy price and risky bet for Pakistan in the medium to long run.
In light of the above brief discussion on this multidimensional subject, the following is suggested for Pakistan's policy makers:

- A gradual and cautious approach should be adopted and no decision should be taken in a haste doing away with the "negative list" in a quick span of time, just 10 months. Such decisions are not made merely to establish soft images but ground realities (economic as well as political and strategic) are also considered accordingly. Gradual and sectoral approach should be adopted for liberalization of trade with India. For the short to medium term, the items that can useful for mutual trade can be added to the "Positive List".
- The passage/transit through Pakistan towards Afghanistan and Central Asia is utmost important for India. It is also detrimental for the interests of world powers, particularly the US, at this point of time. The idea is not to block India's access to Afghanistan and CARs. But the very concept of trade is 'give and take'. Therefore, if Pakistan is granting this big concession, the country should link it with certain concessions from India – economic and political - particularly elimination of NTBs, guarantees for Pakistan's rightful share of water, and assurance that India will not malign Pakistan on pretext of supporting terrorism.
- Concerned government ministries and departments, before the grant of MFN, should prepare a comprehensive study of implications that this decision will have for Pakistan's economy in general and industry and infrastructure in particular. Remedial and precautionary measures should be taken before this major move.
- Business and industrial sectors of the two countries should also build pressures upon the two governments that while enhanced trade will be in favor of both sides; its sustainability will always be very hard to ensure unless the fundamental irritants and sources of tension between the two sides are removed.

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