Working Paper 327

India's Informal Trade with Pakistan

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July 2016

INDIAN COUNCIL FOR RESEARCH ON INTERNATIONAL ECONOMIC RELATIONS

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Abstract

Informal trade continues to thrive between India and Pakistan despite recent measures undertaken by the two countries to normalize trade and reduce transport impediments. This calls for an in-depth analysis of India's informal trade with Pakistan. This study (i) identifies factors determining informal trade, (ii) prepares estimates of India's informal trade with Pakistan (iii) examines the modalities of informal trade (iv) analyzes the transaction cost incurred in trading formally and informally and (v) proposes recommendations needed to shift informal trade to formal channels.

The analysis, carried out on the basis of an extensive survey conducted in India and Dubai estimates informal trade to be US$ 4.71 billion. Of this, India's exports to Pakistan are estimated to be USD 3.99 billion and imports from Pakistan USD 0.72 billion. The study concludes that informal traders in India and Pakistan have developed efficient mechanisms for contract enforcement, information flows, risk sharing and risk mitigation. Further, even though the transaction costs of trading in the informal channel are significantly higher than the formal channel, traders prefer to trade through the informal channel since it is more efficient than the formal channel. An important policy implication is that unless the environment of the formal trade improves, informal trade will not only continue to coexist with formal trade, but it will also impact its potential magnitude in the coming years.

Keywords: *India-Pakistan, informal trade, regional integration*

JEL Classification: F10, F13, F50

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India’s Informal Trade with Pakistan

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1. Introduction

Despite trade liberalization efforts by the South Asian countries, formal trade is abysmally low. On the other hand, informal trade has been a persistent feature of the region and continues to thrive. Analysts regard this growing informal trade to be one of the key reasons for low intra-regional trade in South Asia making this issue an important subject of study in the region.

During 1998-2005 several studies examined the issue of informal trade in South Asia (Pohit and Taneja (2000), Pohit and Taneja (2002), Taneja et al (2005), Rahman and Razzaque (1998), Rao et al (1997) and Sarvananthan, M. (1994)). The focus of the studies was on estimating informal trade, identifying factors that determine these flows and examining the institutional framework which supports it. These studies considered it important to understand the functioning of informal trading markets so that measures could be suggested to improve the functioning of formal markets enabling informal trade to shift to formal channels.

The most interesting country pair in South Asia on this issue is India and Pakistan. The two countries have had a history of strained and restrictive bilateral trade and transport agreements. Even though in recent years measures have been taken to normalize trade and reduce transport impediments, informal trade continues to persist between the two countries. In earlier studies, informal trade between India and Pakistan has been estimated in the range of US$ 250 million to US$2 billion per year (Kugelman 2013, Kochchar and Ghani 2013, Taneja 2004, SBP 2006, Khan et al 2005 and Ahmad et al 2014). If such trade is brought within the ambit of official trade, a significant increase in total trade could be witnessed. Studying the informal aspect of the trading relationship would give deep insights into the functioning of the bilateral economic relationship and help provide policy inputs into the trade normalization process.

In this context the present study (i) identifies factors determining informal trade, (ii) prepares estimates of India's informal trade with Pakistan (iii) examines the modalities of informal trade (iv) analyzes the transaction cost incurred in trading formally and informally and (v) proposes recommendations needed to shift informal trade to formal channels.

2. Framework for Analysis and Methodology

For the purpose of the study, informal trade is broadly defined to include all trade between the two countries that should be included in the national income statistics, according to conventional national income accounting, but is not. Measuring informal trade involves preparing estimates of India’s informal trade with Pakistan in terms of its value, and pattern. Such estimates are important because they would reflect the potential for trade that exists between the two countries.

The study attempts to understand the elements underlying the vitality of informal trading arrangements as well as to identify the bottlenecks of formal trading arrangement between India and Pakistan. Factors influencing informal trade can be classified under three broad categories- (i) those that are related to the policy environment (ii) institutional factors and (iii) non-economic factors. Policy related factors would include those related to trade and transport policies. Trade measures that could encourage informal trade would include high tariffs, non-tariff barriers, restriction on commodities to be traded (Pakistan does not permit imports of 1209 items from India). Transport policies that could impede formal trade and provide an incentive for informal trade include limited number of items permitted by the road route from India to Pakistan, limited number of land routes, and restriction on movement of containerized cargo by the land route. Institutional bottlenecks in the formal channel could also drive potential formal trade to informal channels. For instance, officially traded goods might be subject to complex, and non-transparent regulatory requirements and customs procedures. The infrastructure supporting formal trade could be weak, adding to the transaction costs. Inadequacy in the payments mechanism would also raise transaction costs of trading formally. Information asymmetries in formal trading markets restrict the development of business relationships. On the other hand informal trading markets may offer better institutional support. Payments can be made quickly without using banking channels. Informal markets may also provide a network that not only facilitates information flows but also helps build business partnerships. India and Pakistan trading is also influenced by non-economic factors like political tensions between the two countries, fear of trading officially or possible harassment of official agencies which inhibit businesses from using formal channels.

As and when inadequacies in the formal channel of trading are corrected informal trade is expected to shift to the formal channels. In the present context it is also argued that while both institutional arrangements i.e. the formal and informal, facilitate trade in goods across countries, they are carried out at a cost viz., transactions cost. A rational behavior would imply that a more efficient institution (in terms of lower costs) should be preferred over less efficient one (Coase 1960).

To prepare estimates of the value of unrecorded trade flows, analysis based on secondary data may not be very meaningful and the only method left to estimate informal trade flows is through primary surveys. Some studies have attempted to estimate the value of illegal trade activities through Partner-Country data comparison (Sarvananthan 2001). In practice, this form of informal trade is carried out by under/over invoicing of exports/imports. Basically, the method is to compare the export/import data of the trading partners concerned. The important point is that this method uses recorded trade statistics. A country's export of a particular good should equal the import of the same good by its trading partner and vice versa. If not, then it may be inferred that false invoicing is taking place. The extent of informal trade is hence measured by the degree of fake invoicing. However there are several caveats to this method. For instance there could be errors in measuring freight and insurance costs because of which trade estimates could be inaccurate. Partner-Country data comparisons may not be accurate because one country's export may be accounted in one fiscal year and its trading partner's import of the same good may be accounted in another fiscal year. Also such comparisons may also be less effectual when faking of invoices takes place at both ends of the international trade (Taneja 2002). This is more likely the case when both the trading partners are developing countries. In the case of India and Pakistan, where trade recording systems are poor partner country data comparisons may not reveal the real extent of fake invoicing.

Thus, international trade data present considerable difficulties for partner-country data comparison. Moreover, if trade is not recorded at both ends which is a prominent feature in the South Asian countries including India and Pakistan, then partner-country data comparison is not a valid method. As our present study defines informal trade as unrecorded trade flows that are not captured by official national statistics we need to use primary data generated through a survey for quantification of such flows.

The magnitude and pattern of India's informal trade with Pakistan was estimated through primary surveys covering both formal and informal traders in India and Dubai using Delphi technique, which is essentially a set of procedures for eliciting and refining the opinions of a group of respondents over successive rounds of interviews. The responses from the first round of interviews with a group of respondents are synthesized and the results presented to each respondent of the group in a second round of interviews, to enable respondents to reconsider their responses. The responses obtained in successive rounds are based on feedback provided to the group from previous rounds. The iterations continue until a consensus emerges or until reasons for a lack of convergence are documented. The basic characteristics of this technique are as follows:

- Structured questionnaire based interrogation of experts (knowledgeable people) on the issues being probed.
- Providing summarised responses of the first round to the respondents of the group to enable them to review their response in the second round.
- Repeat iterations till broadly converging responses are received or reasons for lack of convergence are documented.
- Anonymity of responses.

For the purpose of the study, some modifications of the Delphi technique were carried out. First, semi-structured format of direct/informal discussion was carried out with the respondents where they were asked identical questions based on pre-designed guidelines. The survey was designed to capture the volume and aggregate and item-wise value of informal trade, characteristics of business, trade features, custom process and transaction procedures involved in the trade. Respondents were asked to give an estimate of their perception of the value of commodity-wise informal trade and commodity-wise value of trade carried out on a particular route. Some respondents in the primary survey were hesitant to share some information, for example, regarding their personal identity, routes through which specific goods are being traded and the overall mechanism of these trades. This information was solicited through loosely structured conversation with people who had specialized knowledge about the informal trading mechanism hereby referred to as "knowledgeable persons" and formal traders.

Moreover, the rounds of iterations among participants were limited to just two, as there was very little divergence in the responses collected over the two rounds and the respondents exhibited unwillingness to answer the questions a third time around.

The Delphi technique was then complemented with *monitoring techniques*. Movement of cargo was tracked at different ports. The team observed traders at "active" border crossing points, airports, and railway stations. This is a popular technique for collecting primary data on informal trade (Ackello-Oguto, 1996, Peberdy, 2002 and Azam, 2006). Tracking the movement of cargo was sometimes difficult and drew considerable suspicion because the team was mistaken for either policemen, or customs personnel. To avoid this, the team maintained a minimal level of contact and identification with the police and customs personnel in order to win the confidence of the traders.

3. Sample Design

A total of 247 respondents were covered across 8 Indian cities- Ahmedabad, Amritsar, Chennai, Delhi, Hyderabad, Kolkata, Mumbai, Surat and Dubai. The number of respondents in each city and in each category is shown in Table 1.

Table 1: City-wise Break up of Respondents

City	Formal Trader	Informal Trader	Knowledgeable Person	Total Respondents
Ahmedabad	5		4	**9**
Amritsar	11	22	12	**45**
Chennai	4	3	5	**12**
Delhi NCR	5	21	1	**27**
Dubai	28	25		**53**
Hyderabad	4		4	**8**
Kolkata	4	1	3	**8**
Mumbai	41	27	2	**70**
Surat	8	7		**15**
Total	**110**	**106**	**31**	**247**

Source: ICRIER Survey September 2013- March 2014

Of the total respondents, 45% were formal traders, another 43% were informal traders and remaining 12% constituted the 'Knowledgeable Persons' category. For obtaining estimates of informal trade some information was elicited from the 'Knowledgeable Persons' category which comprised of officials at the ports, customs officials and other knowledgeable persons.

The sample of formal traders was selected on the basis of information provided by the chambers of commerce in selected cities in India and Dubai. On the basis of consultations, formal traders who had knowledge about informal trade were selected. Some of these traders were engaged in informal trade as well but did not want to be classified as informal traders. The sample of formal traders also included logistics service providers who were transporting informally traded goods.

Subsequently, the list of informal traders to be interviewed in different cities was prepared on the basis of discussions with knowledgeable persons. Such a selection procedure may lead to a biased sample.

The study also has limitations. First, estimates are based upon knowledge of respondents. Second, the sample selection in the study may be biased. Third, given the nature of the sample of respondents, the survey estimates may only be *indicative*. Fourth is the exclusion of unofficial capital transfers between India and Pakistan. As capital transfers are not allowed officially (unless for investment in joint ventures) between India and Pakistan there is a thriving informal market for capital transfers between the two countries (usually in the form of *hawala*[1]).

4. Why Informal Trade takes place?

Based on the analytical framework, the questionnaire was designed to elicit responses on the reasons for informal trade. Respondents were allowed to give multiple responses which meant that each respondent could give more than one reason for informal trade. An examination of factors that influence informal trade is important to understand the bottlenecks of formal trading arrangements between India and Pakistan. The survey included responses on factors influencing informal exports from India to Pakistan and informal imports to India from Pakistan.

The survey revealed that 89% of traders in India found Pakistan's negative list of 1209 items as the most important factor behind India's informal exports to Pakistan (Graph 1). Pakistan maintains a list of 1209 items on the negative list. These are items that are not allowed to be imported from India. Moreover, there is a restriction on the Wagah road route- only 137 items are allowed to be exported from India to Pakistan via the road route. This impediment is clearly related to the policy environment. These restrictions give a strong incentive for negative list goods to be traded informally from India to Pakistan largely through third countries. The survey showed that more than 50% of the products being exported informally from India to Pakistan were on the negative list.

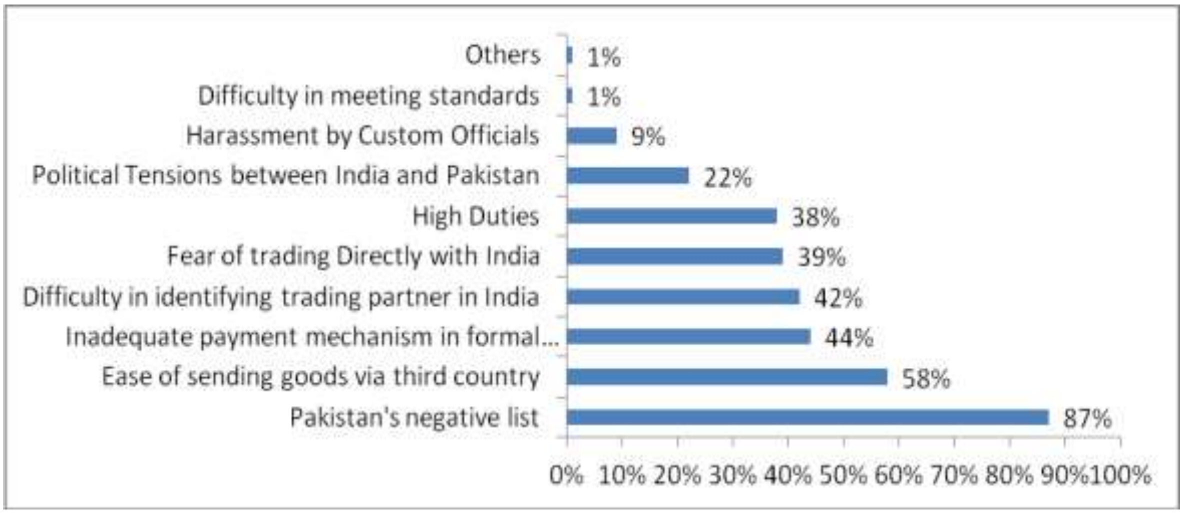
The second most important factor for informal exports to Pakistan, identified by 58% traders, was the ease of sending goods via third country. This reflects the weakness of the infrastructure supporting formal trade which often results in high transport costs in the region and creates a strong incentive for trade to take place through informal channels. Even though India and Pakistan share a long land border, trading between India and Pakistan is allowed only by road and rail along the Attari/Wagah border in Punjab. The Attari/Wagah road route being the only operational route limits the number of items permitted for export from India to just 137 items.

[1] *Hawala* by definition is a traditional system of transferring money used in Arab countries and South Asia, whereby the money is paid to an agent who then instructs an associate in the relevant country or area to pay the final recipient.

The exports which cannot be exported by the road route are being exported at a much higher cost by sea instead of the alternative rail route. In case of India-Pakistan trade, surface transport should be the most convenient and least costly option for moving cargo across the border but this is not the case because the rail route operating between India and Pakistan is in a deteriorating state. There are issues of non-availability of wagons, lack of warehousing, no-fixed schedule of running of trains, pilferage, etc. In addition, customs efficiency in terms of processing time of documents, time taken for lab testing and checks for security is also a problem at mostly all ports currently operational for trading with Pakistan (Taneja et al 2016). Thus the land route becomes an unattractive option for traders.

The sea route has fewer problems. It has been reported that in India a 100% security check is conducted on all consignments from Pakistan at sea ports. This makes trading through the direct route more cumbersome. As a result traders prefer sending their goods via third country. Traders have also developed efficient mechanisms through their contacts in third countries for obtaining information on quantities and commodities to be traded and mitigating risks that might arise in the unofficial transacting environment (Taneja et al 2013).

Graph 1: Reasons for India's Informal Exports to Pakistan (Percent of Respondents)



Source: ICRIER Survey September 2013- March 2014

The third most important factor for informal exports to Pakistan, identified by 44% traders, was inadequate payment mechanism in formal channel. Traders often find it difficult to send payments directly to the other country since India and Pakistan don't have presence of domestic banks in the each other's country. There is no formal mechanism for dispute resolution too. Several traders pointed out that some Indian banks do not recognize L/Cs from all Pakistani banks. Also confirmation of L/Cs takes up to a month. Sometimes payments are delayed as the banks point out discrepancies in the L/Cs. As a result of these problems, payments are usually routed through third country banks which take 4-7 days to remit the payment. To avoid this delay, traders prefer to use the informal channel which is faster and more secure. What is not commonly known is the fact that even if India and Pakistan do not have domestic banks in the other country, transactions can easily take place through *corresponding bank arrangements* via

Nostro accounts. Corresponding bank arrangement is an arrangement under which one bank (correspondent) holds deposits owned by other banks (respondents) and provides payment and other services to those respondent banks (IMF 2008). When banks have such an arrangement with each other, then payment transfer can take place without the interaction or involvement of an intermediary bank. If Indian and Pakistani banks have *Nostro* accounts in the banks of the other country[2], payments can be made within a day or two. Lack of awareness of such options by traders is an indication of large information asymmetries which increases the cost of direct trading between the two countries.

Difficulty in identifying trading partner in Pakistan was identified as another reason for informal trade by 42% of the respondents. India and Pakistan follow a restrictive visa regime. Granting city-specific visa, requirement of police reporting on arrival and before departure; requirement of exit from the port of entry and delays in granting visas are some of the restrictions that limit market access for aspiring traders[3]. Additionally, limited channels of communication, lack of transparency, market imperfections, and information asymmetries raise transaction costs and further restrict market access for traders.

Fear of trading directly was also reported as a reason for informal trade by 39% of the respondents. This is linked to the strained political relations between the two countries. Traders in India reported harassment and questioning from officials which prevented them from entering into direct formal trading relationship.

Imposition of high tariffs was also reported as a reason for informal exports by 38% of the respondents. High tariff rates create a strong incentive to avoid the formal channel in order to evade tariffs. With compliance to the tariff liberalization plan of SAFTA, a phase out and cut down in tariffs is expected. To the extent that high tariffs encourage the use of informal channels a shift from informal to formal trade can reasonably be expected to occur.

Twenty two percent of the respondents also reported the political tension between India and Pakistan as another reason for the existence of informal exports. This is a non-economic factor but it has to be kept in mind that prior to the 1947 partition of the sub-continent, India and Pakistan were in fact a single country politically, economically and monetarily. This historical fact continues to be relevant since some part of the informal trade flourishes because of the traditional, historical, and ethnic links. Perhaps what lie at the core of informal trading markets between India and Pakistan are the close ethnic ties. A common language, religion, culture, etc plays a crucial role in facilitating informal trading across the border.

Harassment by custom officials was also reported as a reason for informal trade by 9% of the respondents. Lastly, only a few traders reported difficulty in meeting standards as a problem.

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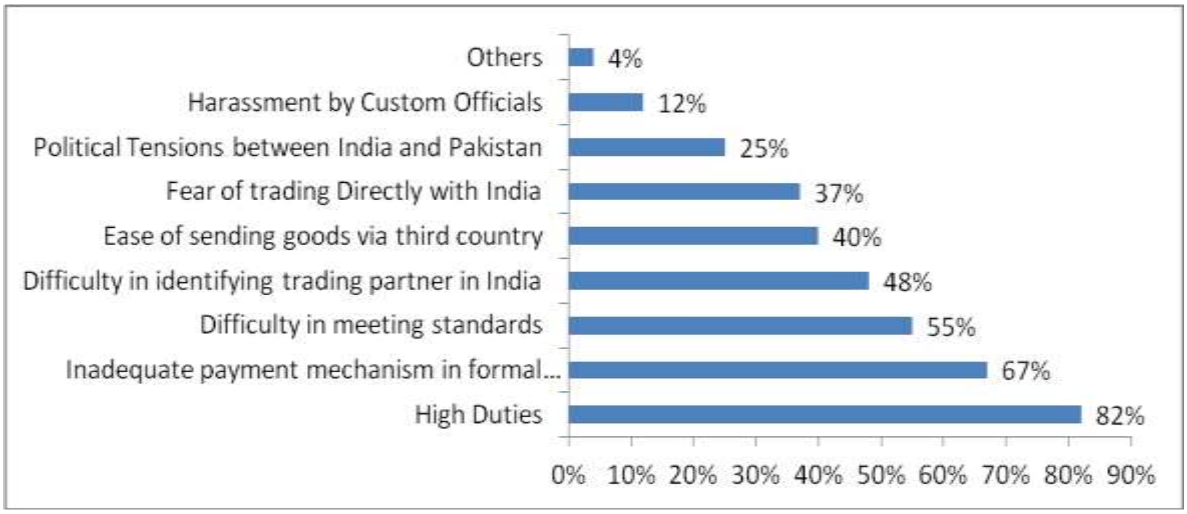
2 Nostro Account: Bank account established in a foreign country usually in the currency of that country for the purpose of carrying out transactions there. For example most commercial banks maintain US dollar accounts with their correspondent banks in USA in order to facilitate settlement of interbank and customer transactions in US dollar.

3 Taneja *et. al.* (2011) "Issues in India-Pakistan Trade Negotiations", *Economic and Political Weekly*, Vol. XLVI, No. 30, July

On India's informal imports from Pakistan, the survey shows that high duties imposed by India was the most important factor influencing informal trade. While this was not amongst the top reasons for India's informal exports to Pakistan, it was reported as the most important reason for informal imports from Pakistan. Over the last few years, India has reduced tariffs under SAFTA to a maximum of 5%. However, it continues to maintain a sensitive list of 614 items on which no tariff concessions are granted.

Other reasons reported for informal imports from Pakistan are: inadequate payment mechanism in formal channel (67%), difficulty in meeting standards (55%), difficulty in identifying trading partners in India (48%), ease of sending goods via third country (40%), fear of trading directly with India (37%), political tensions (25%) and harassment by customs officials (12%).

Graph 2: Reasons for India's Informal Imports from Pakistan (Percent of Respondents)



Source: ICRIER Survey September 2013- March 2014

The essence of our study is that policy and institutional factors play an important role in influencing informal trade flows. With more liberal, non-discriminatory and transparent policies and improvements institutional functioning of formal markets, a shift from informal to formal channels can be expected to occur.

5. How does Informal Trade take place?

Major Routes and Modalities of Informal Trade

Most of India-Pakistan informal trade flows through third country, in particular Dubai. One can broadly outline seven routes through which informal trade between India and Pakistan takes place:

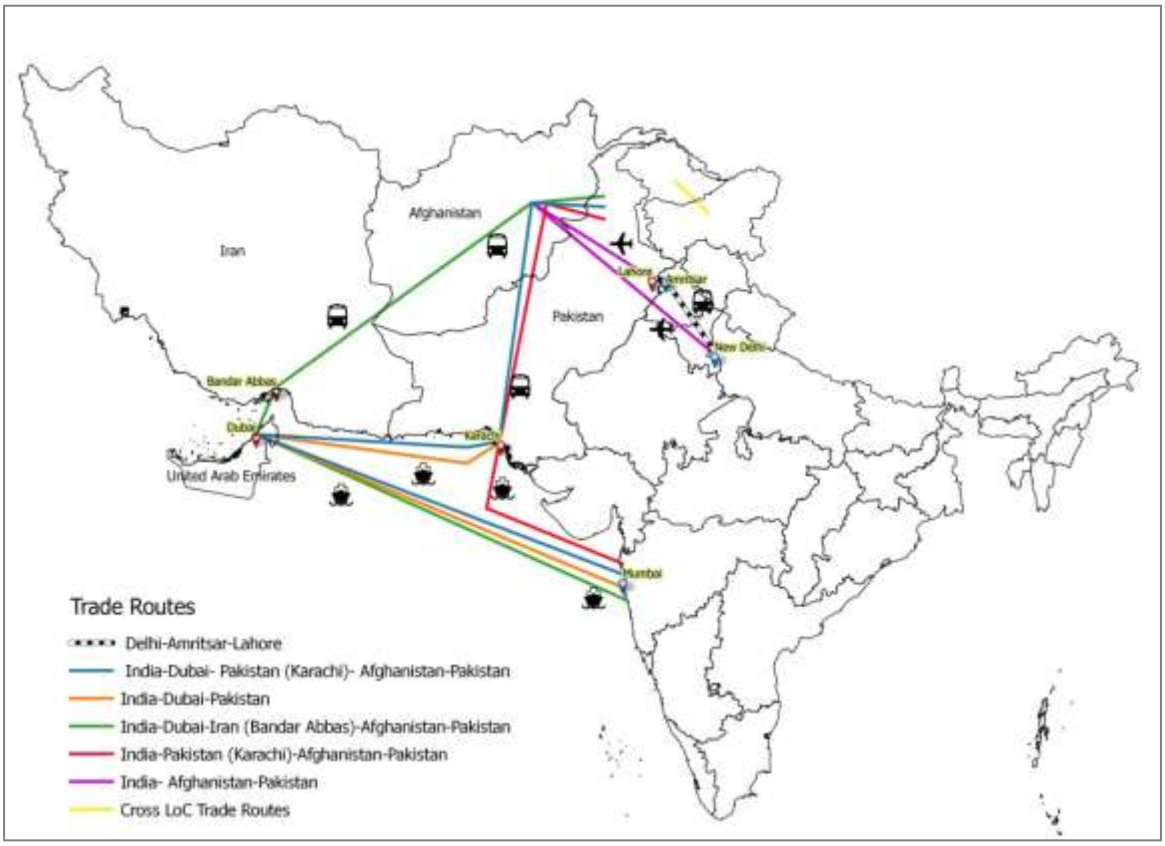
1. India-Dubai-Pakistan
2. India-Dubai-Iran (Bandar Abbas)-Afghanistan-Pakistan
3. India-Dubai- Pakistan (Karachi)- Afghanistan-Pakistan (sea and land route)

4. India-Pakistan (Karachi)-Afghanistan-Pakistan (sea and land route)
5. India- Afghanistan-Pakistan (air route)
6. Delhi-Amritsar-Lahore (passenger bus/rail)
7. Cross LoC Trade Routes (Uri-Salamabad and Poonch-Rawalkote)

The first route i.e India-Dubai-Pakistan is the main channel for quasi-legal trade. Trade is recorded between India and UAE and between Pakistan and UAE but is unrecorded between India and Pakistan. At Dubai, the goods are stamped with a country of origin other than India. There are some cases when trade modality is conducted through a “switch bill of lading”. In such an arrangement, ships containing items not allowed for import in Pakistan, are supposed to travel to Karachi via a third port (e.g. Dubai). In reality, however, the ships travel directly from an Indian port to Karachi (Khan et al 2007, Taneja 2006). The bill of lading of that ship, which shows its origin, is switched in the documentation to Dubai. This process is completed even before the ship has left the Indian port.

The second, third, and fourth route are basically the Afghan transit routes, wherein goods are destined for Afghanistan (either directly or through Iran or Pakistan) but make their way into Pakistan informally en-route or through the North-western parts of Pakistan. The goods reaching Pakistan enter with an origin change.

Figure 1: Major Informal Trading Routes between India and Pakistan



In route 2, goods move officially from India to Dubai. The containers are shipped to Dubai and from Dubai to Bandar Abbas (in Iran) from where goods are transported overland by trucks to Afghanistan and finally to Pakistan.

In route 3, goods move by sea from an Indian port to Karachi port in Pakistan via Dubai and then move to Afghanistan by road and further on enter into Pakistan informally. In route 4, goods move by sea from an Indian port to Karachi port in Pakistan then move to Afghanistan by road and further on enter into Pakistan informally. In both route 3 and 4, sometimes goods are deflected en-route (see Box 1).

Box 1: Dubai as a trading hub for India-Pakistan Trade

Case Study 1: Informal Trade of Machinery
During our survey, we came across an instance where a machine that was exported from Kolkata to Pakistan via Dubai with fresh documentation and different country of origin was caught at the destination port in Pakistan port since it was wrapped in a leading Indian daily. The documentation of the consignment was complete and reflected a different country of origin but the wrapping in an Indian newspaper led to suspicion among officials and finally the exporter was levied a huge fine.

For several years, Dubai has been used as a common ground for conducting trade between India and Pakistan. Dubai is easily accessible from both India and Pakistan in terms of travel, and logistics and has a significant number of Indian and Pakistan diaspora. Dubai has duty-free zones, a business friendly environment for trade, no direct taxes on corporate profits or personal income, 100% repatriation of capital and profits and no foreign exchange controls, trade quotas or barriers.

Since channels of communication are weak between India and Pakistan, traders from both sides have often relied on agents or middlemen of Indian or Pakistani origin in Dubai who bring together the buyers and sellers in both countries and facilitate trade transactions. A strong network of traders and a large ethnic community from the two countries enables free flow of information on commodities to be traded between the two countries. Advertisements aired on television in Dubai are also an important source for identifying the possible products that can be traded between the two countries. Such market forces do not exist in India and Pakistan due to a restrictive media regime. The trade contract is executed in two legs: the middleman/agent in Dubai signs a contract with the buyer and separately with the seller and takes responsibility for quality, procurement, documentation and delivery. He is a guarantor and bears the risk in the transaction.

Most agents import the products into free zones in Dubai and re-export it within the stipulated time with fresh documentation and in this way evade duties. Indian bill of lading shows Dubai as the destination and the product is re-exported to Pakistan. In cases where there is evidence that the product is from India, a huge penalty is imposed. In such circumstances, the consignment is either returned or accepted on payment of bribe. Such trade is usually financed through letters of credit (entered separately between importer-agent and agent-exporter), cash transactions or *hawala*.

In sum, Dubai has facilitated trade by bringing buyers and sellers together, bridging the information gap and playing the role of a risk guarantor-ensuring that goods reach their destination and payments are made.

In route 5, goods are destined for Afghanistan but come back to Pakistan informally by the land route.

The survey reflected interesting insights into the three sub-routes through Dubai, namely routes 2, 3 and 4. An important aspect is that traders selected the routes because of different reasons. Even though India-Dubai-Iran (Bandar Abbas)-Afghanistan-Pakistan (route 2) was the longest and most expensive in terms of transportation cost, the customs point at Iran/Afghanistan border has weak enforcement and hence no duties are charged when goods enter into Afghanistan. This makes the route attractive for goods with *high duties*. Goods drawing duties in the medium range are sent through India-Dubai- Karachi- Afghanistan-Pakistan (route 3). Finally, goods that have very low duties are sent directly through Dubai to Karachi (route 1).

Trade on the Amritsar–Lahore route is conducted through the "Samjhauta Express" train, which operates twice a week. Informally traded items are brought by genuine passengers looking to cover the cost of their trip or by professional informal traders (called "Khepias"), who travel on the train on a frequent basis and carry large quantities of goods from India to Pakistan and vice versa. The goods are taken to established wholesale markets in Lahore and Delhi from where they are either distributed to retail markets within the city or transported to other cities.

The seventh route is the cross-LoC route under which barter trade is allowed through Uri-Muzzafarabad trade route and the Poonch-Rawalakote trade route on an agreed upon list of 21 items that are of Kashmiri origin. The list is ambiguous leaving room for a number of items to be traded. Since no duties are charged on cross-LoC trade, this route becomes very attractive for informal traders especially in products where import duty is high. Transactions get reconciled between both sides on trade books but payment transactions get reconciled through *hawala*[4].

6. Survey-Based Estimation of India-Pakistan Informal Trade

The survey-based estimates of India-Pakistan informal trade show that total informal trade is US $4.71 billion. Of this, India's exports to Pakistan are estimated to be USD 3.99 billion (Table 2) and imports from Pakistan are USD 0.72 billion (Table 3). The estimates are for the year 2012-13. Similar to formal trade, the balance of informal trade is also tilted in favor of India.

[4] The uniqueness of this system is that there is no physical transfer of currency. This mechanism, referred to as the 'hawala' in India and Pakistan, operates on the same principles. Thus an Indian exporter, who exports goods to Pakistan, gets his payment through the 'hawala'. The dealer in Pakistan sends an 'I owe you' to the dealer in India and the requisite equivalent amount is paid to the exporter. The 'I owe you' is analogous to cash or cheque in the modern banking system.

Table 2: India's Informal Exports to Pakistan- Estimated Value (2012-13)

Products	Value (In Million $)	Share (%)	Average Duty[5] (%)	Negative List[6]	Sensitive List[7]
Real Jewelry (Diamond, gold, precious stones, etc.)	910	23%	5	✓	✓
Textiles	780	20%	12.5	✓	✓
Machinery and Machine Parts	305	8%	20	✓	✓
Electronic Appliances	220	6%	17.5	✓	✓
Scraps	193	5%	17.5	✓ (scrap of auto parts)	
Paper	190	5%	15	✓	✓
Chemicals	187	5%	17.5	✓	✓
Tyres	187	5%	15		✓
Packaged Food Items	170	4%	30		
Spices	160	4%	10		
Pulses	156	4%	7.5		
Consumer Durable Items	150	4%	30		✓
Industrial Additives	133	3%	15	✓	✓

5 Average duty calculated from Customs Tariff Manual 2012-13, Federal Board of Revenue, Government of Pakistan
6 Pakistan maintains a negative list of 1209 items that are prohibited from being imported from India.
7 Corresponds to Pakistan's sensitive list under SAFTA. Sensitive list comprises of products that are exempted from tariff concessions offered under SAFTA.

Pharmaceutical Products	83	2%	15	✓	✓
Jewelry (Artificial)	28	1%	7.5		✓
Pan Leaves/Betel Leaves	26	1%	Rs 200/kg		
Alcohol	22	1%	90		✓
Coconut Oil	20	1%	Rs.10800/MT		
Tea	16	0%	25	✓	
Shaving Blades	15	0%	10		✓
Fruits and Vegetables	12	0%	15		✓
Pan Masala	8	0%	30		
Tobacco Products	6	0%	30	✓	✓
Leather	5	0%	22.5	✓	
Auto Components	4	0%	35	✓	✓
Stone	3	0%	27.5	✓	
Furniture	2	0%	20	✓	✓
Aampapad	0.5	0%	30		
Soda bottles	0.5	0%	25		✓
Total Informal Exports from India to Pakistan	**3992**	**100%**			

Source: ICRIER Survey September 2013- March 2014

The survey estimates show that real jewelry including gold, diamonds and precious stones is the single largest commodity traded informally from India to Pakistan accounting for 23% of India's informal exports to Pakistan. This high value jewelry is hand carried either by air through Dubai or even with passengers in Samjhauta Express. Artificial jewelry is also exported informally to Pakistan. Though this amount is not very significant and comprises just 1% of our informal exports, the survey has reported informal exports of artificial jewelry which includes bridal sets, bangles and lockets. Ahmed et al (2014) point out that there are 150 shops in Karachi, Lahore and Rawalpindi, which deal in artificial Indian Jewelry.

Textiles is the second largest item being exported informally even though it is allowed to be exported formally in the positive list. There is demand for Indian synthetic fabric, silk-based fabrics and salwar kameez dupatta in Pakistan. Majority of these textiles are going from Surat, Gujarat and South India.

Case Study 2: New Textile Market, Surat

The New Textile Market is a major textile hub in Surat with about 50,000 members. About 42,000 of its members are exporting overseas. The main export items of these exporters are Salwar Kameez Dupatta (SKD) and dyed and other fabrics etc. About 90 percent of these exporters export to Pakistan via Dubai and only 10 percent do it directly. The ones exporting directly are mainly exporting dyed fabric through the road route.

Other items like Salwar Kameez Dupatta, polyester and synthetic fabrics are traded via Dubai. Traders from Dubai come to Surat and place orders for goods to be sent to Dubai. Traders in Surat then send their goods to Mumbai and further to Dubai and finally Karachi. Traders ensure that there is no *Made in India* label on the fabric before exporting to Dubai.

Traders have to incur huge transaction cost and the consignment takes a long time to reach its final destination. But, because of lack of awareness about the possibility of direct trading, lack of information on trade policies and the difficulty in identifying trading partners in Pakistan, traders in Surat rely on the Dubai route rather than on formal direct trading route.

High value machinery is another important item being exported to Pakistan informally. Industrial, textile, packaging, printing and pouch-making machinery were reported to be exported to Pakistan informally via Dubai. Traders use interesting methods to export machinery. For instance, printing machinery is sometimes sent along with a copper scrap consignment and reported as export of scrap to Dubai.

In a recent trend, Indian packaged food products have found an entry into Pakistan markets informally. The demand for Indian tyres', both new and refurbished, has also witnessed a surge in the Pakistan market.

Real jewelry, textiles, machinery and machine parts, electronic appliances, scraps, paper, chemicals, tyres and packaged food items together account for nearly 80% of India's informal exports to Pakistan. The combined share of remaining items which includes spices, pulses, consumer durable items, industrial additives, pharmaceutical products, artificial jewelry, pan masala, tobacco products, etc was 20%.

Indian consumer durable products like cosmetics, deodrants, perfumes, soaps are very popular and are preferred both for their better quality and affordability, compared to the Pakistani and foreign cosmetic products.

Several Indian pharmaceutical products are exported informally to Pakistan either via Dubai or Afghanistan. Medicines such as Aspirin, Amoxicilin, Ampicillin, Cimetidine, Famotidine, Co-trimaxazole, Ciprofloxacin, Laxotanil and Ranitidine manufactured by Indian companies (Liv 52, Serpina, Mentat, Herbdax) are available in the local Pakistani markets. Some of the negative list drugs such as Aspirin and Paracetamol are also reported to be easily available in the local markets (Ahmed et al 2014).

During the survey, it was also observed that Indian alcoholic products are exported to Pakistan primarily by the road route. It was reported that border officials on both sides were the main conduit for this trade.

Tobacco, pan masala and pan/betel leaves were also found to be exported to Pakistan informally. There is demand in the Pakistan market for Indian *gutka* and pan masala. Import of gutka in Pakistan is banned yet Indian gutka and tobacco products can be seen openly in the Pakistan market. Most of these items are exported informally as accompanied baggage in Samjhauta Express.

Case Study 3: Export of Indian Pan/Betel Leaves

Indian pan or betel leaves are carried by *khepias* or *carries* in bulk through the Samjhauta Express. These carriers purchase pan leaves from old Delhi markes located near the railway station at a price of INR 50-60 per Kg. The pan leaves are put in sacks and carried to Pakistan along with their own baggage. These carriers make 2-3 visits a year and on an average carry 2-3 sacks filled with pan leaves to Pakistan. Discussions with some of these carriers revealed that it was easy to locate customer/trader in Pakistan. There is a difference in the selling price of these pan leaves depending on the location of the market. Products sold at the station itself are priced at about INR 200-300 per kg and if sold in some markets located further off the price increases to about INR 400-500 per kg.

An examination of Pakistan’s negative and sensitive list indicates that a substantial proportion of products beings exported informally from India to Pakistan are on the negative list (52%) or on Pakistan’s sensitive list under SAFTA (62%) or on both Pakistan’s negative and sensitive lists (72%). Further, the maximum number of tariff lines in Pakistan’s sensitive list fall under the category of textile items (24 percent) providing the incentive to trade informally in this category. Other important informally traded items such as jewelry, machinery and machine parts, electronic appliances and pharmaceuticals also fall either on the negative or sensitive lists (Table 2). However, there are items that neither come under the sensitive list nor on the negative list and are also subjected to low tariffs. This indicates that a number of factors other than those related to trade policy are at play which influence informal trade flows. If we also look at the import duty structure for the identified products that were reported to being exported informally from India to Pakistan, we find that other than jewelry (both real and artificial), import duty for all the products is over 10% in Pakistan.

India's informal imports from Pakistan amount to US$ 0.72 billion. The composition of informal trade in terms of value from Pakistan to India, as estimated in the survey, shows that textiles is the single largest commodity traded informally from Pakistan in to India. The share of textile products is about 49% of India's informal imports from Pakistan (Table 3). This is not surprising since there is a huge demand for Pakistan textiles in India particularly in cotton lawn salwar kameez dupatta. Indian traders import textiles informally via Samjhauta Express, cross-LoC trade routes and sometimes also through Dubai. An examination of India's sensitive list under SAFTA applicable to Pakistan indicates that 44% of the products informally imported into India from Pakistan fall under India's sensitive list. India's sensitive list under SAFTA has the largest number of items in the textiles sector accounting for 30% of the total number of items on the sensitive list, providing the incentive to trade informally in this category. If we also look at the import duty structure for the identified products that were reported to being imported informally from Pakistan into India, we find that other than textiles, import duty for all the products is below 10% in India.

Table 3: India's Informal Imports from Pakistan- Estimated Value (2012-13)

Products	Value (In Million $)	Share (%)	Average Duty (%)[8]	Sensitive List[9]
Textiles	350	49%	12	✓
Dry Fruits	230	32%	8	
Spices	75	10%	8	✓
Cement	15	2%	6	
Carpets	28	4%	10	
Fruits and Vegetables	12	2%	8	✓
Leather	9	1%	6	
Electronic Goods (Chinese Cameras, ICs, etc)	1	0%	6	✓
Leather chemicals	1	0%	8	
Total India's Informal Imports from Pakistan	**721**	**100%**		

Source: ICRIER Survey September 2013- March 2014

A striking feature of the origin of goods traded informally is that while informal trade in goods traded from India to Pakistan comprise wholly of locally produced goods in India, informal trade in goods moving from Pakistan to India includes both goods domestically produced in Pakistan and goods that originate in third countries. Notable amongst third country informal imports into India are Afghanistan made carpets, electronic goods manufactured in China and California almonds.

8 Average duty calculated from Central Board of Excise and Customs, 2012-13, Government of India

9 Corresponds to India's sensitive list under SAFTA applicable to Pakistan (Non-Least Developing Country).Sensitive list comprises of products that are exempted from tariff rates offered under SAFTA.

Table 4: Route-wise Estimates of India's Informal Exports to Pakistan (2012-13)

Routes / Products	India-Dubai-Pakistan (Route I)	India-Dubai-Iran (Bandar Abbas)-Afghanistan-Pakistan (Route II)	India-Dubai-Karachi-Afghanistan-Pakistan (Route III)	India-Afghanistan-Pakistan (Route IV)	India-Pakistan (Karachi)-Afghanistan-Pakistan (Route V)	Delhi-Amritsar-Lahore* (Route VI)	Cross LoC Trade Routes** (Route VII)	Value (In Million $)
Real Jewelry	518		222			170		910
Textiles	246		164	31		285	54	780
Machinery and Machine Parts		110	164			31		305
Electronic Appliances	41	62	104			13		220
Scraps	25	42	101			24		193
Paper	80	10	19		67	14		190
Chemicals	45	60	43			39		187
Tyres	20	75	30	21		41		187
Packaged Food Items	170							170
Spices	12					138	10	160
Pulses						156		156
Consumer Durable Items	120	5	25					150
Industrial Additives	15	32	70			12	4	133
Pharmaceutical Products	25		25	33				83
Jewellery (Artificial)	19		2			7		28
Pan Leaves/Betel Leaves						26		26

Routes / Products	India-Dubai-Pakistan (Route I)	India-Dubai-Iran (Bandar Abbas)-Afghanistan-Pakistan (Route II)	India-Dubai-Karachi-Afghanistan-Pakistan (Route III)	India-Afghanistan-Pakistan (Route IV)	India-Pakistan (Karachi)-Afghanistan-Pakistan (Route V)	Delhi-Amritsar-Lahore* (Route VI)	Cross LoC Trade Routes** (Route VII)	Value (In Million $)
Alcohol	5					17		22
Coconut Oil						16	4	20
Tea					8	8		16
Shaving Blades	2	1	2			10		15
Fruits and Vegetables						4	8	12
Pan Masala	3		2			3		8
Tobacco Products	3					3		6
Leather	1	1	2			1		5
Auto Components		1	2			1		4
Stone	1					2		3
Furniture	2							2
Aampapad						0.5		0.5
Soda bottles						0.5		0.5
Estimated Value of India's Informal Exports to Pakistan	**1354**	**399**	**977**	**85**	**75**	**1022**	**80**	**3992**
Percent share	**34%**	**10%**	**24%**	**2%**	**2%**	**26%**	**2%**	**100%**

Source: ICRIER Survey September 2013- March 2014

* corresponds to passenger bus/rail

***corresponds to Uri-Salamabad and Poonch-Rawalkote trade routes

Majority of India's informal exports to Pakistan are routed via third country. About 68% of India's informal exports to Pakistan are routed via Dubai (detailed route-wise breakup given in Table 4). Informal trade through Delhi-Amritsar-Lahore passenger bus/rail accounts for 26% of the total informal exports. Informal exports through Afghanistan accounts for 4% and cross-LoC trade route accounts for 2% of India's total informal exports to Pakistan (Table 4).

Survey results on route-wise estimates of India's informal imports from Pakistan show that 59% is accounted for by passengers travelling by bus or rail. Informal imports via the cross LoC trade routes and Dubai account for 24% and 17% respectively (Table 5). About 30% of textile items flow into the Indian market through the cross LoC route primarily to evade tariffs. A detailed examination of India's sensitive lists shows that textiles account for 30% of items on India's current sensitive list of 614 items (Taneja et al 2013). This is an indication of that fact that once India liberalizes its tariffs, a shift from informal to formal channels can be expected in textiles.

Table 5: Route-wise Estimates of India's Informal Imports from Pakistan (2012-13)

Routes / Products	Via Dubai*	Lahore-Amritsar-Delhi**	Cross LoC Trade Routes (Uri-Salamabad and Poonch-Rawalkote)	Trade Value
Textiles	96	153	101	350
Dry fruits		167	63	230
Spices		75		75
Carpet		20	8	28
Cement	15			15
Fruits and Vegetables		9	3	12
Leather	9			9
Electronic Goods (Chinese Cameras, ICs, etc)		1		1
Leather chemicals		1		1
Rough Value of Informal Exports from Pakistan to India	**120**	**426**	**175**	**721**
Overall	**17%**	**59%**	**24%**	**100%**

Source: ICRIER Survey September 2013- March 2014

*Note: * corresponds primarily to import route Pakistan-Dubai-India*

*** corresponds to passenger bus/rail*

**** corresponds to Uri-Salamabad and Poonch-Rawalkote trade routes*

7. Transaction Cost of Trading

A key question posed in the study is - what are the transaction costs being incurred by traders on alternative routes? The two routes selected for the analysis are the road route through which only a limited number of items are permitted and Dubai route which offers a conducive environment for trade between India and Pakistan.

To understand the trade logistics and transaction costs incurred in trading with Pakistan information was sought from freight forwarders and customs house agents. Transport and other transaction costs, which included official charges (loading and unloading charges at ports and land customs station), were obtained for a 20 feet ship container load of 18 tons of soy meal. This item was selected because it is a homogenous commodity. Transaction costs include transportation costs, official charges related to documentation and port charges and other informal charges.

Table 6 provides a comparison of total transaction costs both in terms of absolute costs and in terms of efficiency measured by costs incurred per container per km- (i) costs per container which allows cost comparisons in absolute terms as traders often do not have the option of transporting goods through the most desirable/direct route and (ii) cost per container per kilometre, which is used as a performance/efficiency indicator for alternative indirect routes

The two routes under study are the Delhi-Lahore direct road route and the Delhi-Mumbai-Dubai-Karachi-Lahore land-cum-sea route. Under the first route, goods are transported by road from Delhi to Amritsar from where they are transported by trucks across the Attari/Wagah border. Under the second route, goods are transported by road from Delhi to Mumbai from where they are transported by sea to Karachi via Dubai (with switch bill of lading).

Table 6: Route-wise Transaction Cost (TC) Per Container (US $)

Route	Transaction Cost Per Ton (INR)	Distance (kms)	Transaction Cost Per Ton per Km (INR)
1) Delhi-Lahore	3050	507	6.01
2) Delhi-Mumbai-Dubai-Karachi-Lahore	12600	5756	2.18

Source: ICRIER Survey

Expectedly, absolute costs are higher on the indirect trade route. On the Delhi-Mumbai-Dubai-Karachi-Lahore route transport and transaction costs are 4 times more than the cost of trading directly between Delhi and Lahore. Freight costs on the Mumbai-Dubai-Karachi route are around US$ 535 for the Mumbai-Dubai leg and US$ 175 for the Dubai-Karachi leg[10]. The difference in the freight costs for these two legs is because freight costs are often determined by the freight trade balance between two countries. Since Pakistan has a trade surplus with Dubai, containers moving back from Dubai to Karachi are not fully loaded and are therefore offered to Indian exporters at concessional rates.

But if we were to measure the extent of efficiency in terms of transaction cost incurred per container-kilometer between the direct and indirect route, than the Delhi-Mumbai-Dubai-Karachi-Lahore route is 2.75 times more efficient than the direct Delhi-Lahore route. Thus, the indirect route is more efficient in terms of transport/transaction cost incurred per container-kilometer (See Table 8 Column 4). The high transaction cost per ton per km at the direct route

[10] ICRIER Survey in Dubai in December 2014

is because of several factors like: limited number of items that can be exported via road route, cumbersome customs checks at Attari/Wagah customs station, some transaction costs are also in the form of bribes incurred in getting customs clearances, physical examination of goods, poor infrastructure, etc.

The key inference to be drawn from the above analysis is that the *indirect route is 11 times longer than the direct route; 4 times more expensive than the direct route; but is almost 3 times more efficient.* Another useful insight is that to overcome barriers posed by the trade and transport regimes, traders have developed alternative routes where markets in trade and transport allowed for greater efficiency. There is not much incentive, then, for traders to use the direct inefficient routes for trade between India and Pakistan. This also explains the persistence of trade through indirect routes for almost seven decades. The switch to direct routes can happen only if there are substantial improvements in efficiency.

8. Major Findings and Policy Recommendations

As India and Pakistan move towards improving their trade relations, it is important to recognize the functioning of informal trade markets and the inadequacies of the formal trading channel. This study makes an attempt to prepare estimates of informal trade between India and Pakistan and provides an in-depth analysis of the factors supporting informal trade, major routes and modalities through which informal trade takes place, institutional mechanism that enables informal trade to take place between the two countries and transaction costs incurred while trading formally and informally.

The study estimates informal trade between India and Pakistan to be US $4.71 billion in 2012-13. Of this, India's exports to Pakistan are estimated to be USD 3.99 billion and imports from Pakistan USD 0.72 billion. The main informal export items are jewellery, textiles, machinery and machine parts, electronic appliances, chemicals, paper, betel leaves and tyres. India's informal imports from Pakistan mainly consist of textiles, dry fruits, cement and spices.

The major reason for informal exports is the presence of a negative list of 1209 items and imposition of high duties is the main reason for informal imports. These impediments are related to the policy environment and give a strong incentive for negative list and high duty goods to be traded informally between India to Pakistan, largely through third country ports like Dubai.

Third country traders, particularly from Dubai, have played a key role as facilitators for informal exports by getting buyers and sellers together and providing guarantee for trade transactions between Indian and Pakistani traders. Until business partnerships can materialize through market forces, payments can be ensured and trust in business relationships can be established, informal trade may not shift to formal channels. Interestingly, for imports the land routes are more important, with majority of informal imports coming through passenger bus/rail and cross LoC trade routes.

A comparison of transaction costs between the direct Delhi-Lahore route and indirect and informal Delhi-Mumbai-Dubai-Karachi-Lahore route shows that the indirect route is 11 times longer than the direct route; 4 times more expensive than the direct route; but is almost 3 times more efficient. This results from the restrictive trade regime and inadequate transport system operating between the two countries.

It is clear that unless the environment of the formal trade improves, informal trade will not only continue to coexist with formal trade, but it will also impact its potential magnitude in the coming years. Since most of the total trade being outside the purview of formal trade relations, both governments lose out a significant revenue stream. We propose the following recommendations which may be useful in the shift from informal to formal trade:

- Elimination of the negative list of 1209 items would allow export of many items that are currently routed via Dubai and other informal channels of trade. Pakistan government can switch to trading in all tradable goods while maintaining some level of protection for its sensitive constituencies.

- Enhancing and strengthening communication among traders of both countries to bridge information gap and asymmetries. More dialogues among traders in both countries would not only help the two countries in understanding each other's trade procedures and regulations but would also lead to a more conducive business environment. Online portals hosting trade related information and discussions on trade, trade fairs, exhibitions and multilevel dialogue are some possible ways for increasing trader's awareness regarding policies that govern trade between India and Pakistan.

- Information on regulatory regimes should be made easily available to traders. For key commodities, flow charts exhibiting the import and export process covering procedures and documents, regulatory requirements and relevant authorities should be displayed on the web portal.

- Currently India offers market access to its SAARC partners at a maximum of 5 percent customs duty on all items except for those on the sensitive list. India offers duty free access to imports from the Least Developing Countries in SAARC (Nepal, Bhutan, the Maldives, Bangladesh and Afghanistan) and to Sri-Lanka as well under the bilateral free trade agreement. Since imposition of high tariffs is one of the important reasons for informal trade, India should extend this offer of zero duty to Pakistan as well, the only remaining Non-Least Developing Country. Lowering of tariffs would reduce the incidence of informal trade and induce a shift of trade flows from informal to formal trade channels. Pakistan should also bring down its SAFTA sensitive list to 100 tariff lines (from the existing 936 items) within the next 5 years, with the peak tariff rate for all other tariff lines not more than 5%.

- Connectivity is an important aspect of strengthening formal trading ties. The inadequate transport and transit systems that have been in existence between India and Pakistan have been a major constraint in enhancing trade through formal channels.

Establishment of better connectivity through improvement of cross border physical infrastructure and amending transport protocols would encourage seamless transportation of goods across land borders. Unless infrastructure development is undertaken on an urgent basis informal trade will continue to be more attractive.

- Transaction costs can be lowered by removing bottlenecks on the direct trading routes. Measures such as simplifying border procedures and introduction of EDI facilities at the land borders would also reduce transaction costs of trading, both in terms of time and money. Containerized cargo by road and rail will improve efficiency of surface transportation. Random security checks should be carried out on import consignments coming into India. A system of authorized trader status could be introduced to reduce security checks at sea and land ports.

- New rail and road links like the Khokrapar-Munabao link and the Ferozepur-Hussainiwala link would reduce transaction costs of trading further.

- In addition to physical transport connectivity, there is a need to improve connectivity through easier visa processes, cellular services and courier facilities.

- Simplification or reduction of documentation requirements and formalities for export and imports would significantly reduce transaction costs. This would incentivize formal trade. This could be complemented with a 'single window' clearance of all trade related documents which would further help in reducing direct transaction costs related to compliance with document requirements and indirect costs related to long customs clearance times.

- Setting up cross border banking facilities would be an important step towards faster payments for traders. Easier access to formal credit and banking systems may encourage traders to use formal channels of trade.

To conclude, informal trade is unlikely to be totally eliminated because ethnic networks between India and Pakistan would continue to facilitate it by reducing transaction costs through minimization of risks, market information and search costs. However, if appropriate measures are taken a substantial proportion of informal trade can be channelized to the formal route. Until all such measures are fully implemented, informal and formal trade between India and Pakistan are likely to co-exist.

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