Kashmir

A Problem in Search of a Solution

Shahid Javed Burki

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United States Institute of Peace
1200 17th Street NW, Suite 200
Washington, DC 20036-3011

Phone: 202.457.1700
Fax: 202.429.6063
E-mail: usip_requests@usip.org
Web: www.usip.org

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SUMMARY

The ongoing territorial dispute between India and Pakistan over the status of the contested areas of Jammu and Kashmir (henceforth Kashmir) is well known and well documented.[1] This study acknowledges that any resolution of this dispute may be many years in the making. Thus, rather than proposing solutions to the territorial conflict, the study explores the utility of forging enhanced economic opportunities for the people of the region and argues that doing so may prepare the ground for the eventual resolution of the dispute. Many of the proposals advanced here will require all the parties to the dispute—India, Pakistan, and the people of the divided state of Kashmir—to agree on a suite of programs that would bring about positive economic change from which there cannot be any turning back. I believe that such positive change would create vested interests and beneficiaries that would resist any retrenchment from continued progress.

Pakistan may require particularly robust focus because it must deal with unique incentives to spoil such normalization, as numerous parties there currently benefit from sustained conflict with India. Indeed, Pakistan—perhaps more so than India—has already paid a heavy price for the conflict, particularly for its reliance on political and even militant Islam as an integral aspect of the country's defense strategy and domestic policies. As a consequence of decades of instrumentalizing Islam for political reasons, militant and obscurantist versions of the religion have become entrenched within layers of Pakistan's civil society and have affected Pakistan's political and social development.

Although India has not suffered in this way, it has incurred a different set of costs for its own intransigence in the face of the Kashmir dispute. While India's Kashmir war was fought on a conventional basis early on, the conflict did not affect its society or the political system beyond the disputed territory of Kashmir. However, an argument can be made that the Kashmir dispute has migrated throughout India and has become intertwined in long-standing communal conflicts between proponents of Hindu nationalism (Hindutva) and India's own Muslim communities, as evidenced by the recent episodic massacres of Muslims (e.g., the riots associated with the demolition in 1992 of the mosque at Ayodhya and communal riots in Gujarat in 2002).[2] For a time, Kashmir's distance from India's main population centers somewhat distanced the conflict from Indian society. However, this situation has changed in recent years with terrorist attacks in India's hinterland and even in the evolving relationships between the ostensibly secular state of India and its various religious communities. Needless to say, the Kashmiris themselves, particularly those living in Indian-administered Kashmir, have borne the direct brunt of the violence perpetrated by Indian security forces and Islamist militants, and have had to survive the devastation of the civil war.

While the direct costs borne by all parties to the dispute have been enormous, the opportunity costs have been equally significant. Although both governments tend to downplay the actual costs of the conflict, there is little evidence that either side understands—or even considers—

the extent of these opportunity costs. Furthermore, the governed people are scarcely aware of the magnitude and kinds of opportunities that have been sacrificed. Entering these notions of the conflict's direct and opportunity costs into public debate may be an important step in cultivating constituents for normalization and resolution of the dispute.

This study makes two major contributions to the massive literature on the Kashmir dispute and proposals to "resolve" it. First, it posits the notion of opportunity costs and provides some estimates as to their magnitude. It is hoped that once the respective publics understand the full range of impacts of their governments' policies, they may demand new approaches. Second, the study proposes a number of means of creating *new* economic opportunities to create new constituencies for peace. This contribution relates to the first because it suggests that opportunity costs are imposed not only by the actions of Islamabad and New Delhi but also by their inaction. By failing to consider and pursue innovative economic ideas, the capitals are imposing another lost opportunity on their peoples and the Kashmir populations living under their respective control.

The new opportunities explored here involve moving along three fronts simultaneously. First, India should grant autonomy to the state well beyond that promised in Article 370 of its Constitution. Second, India and Pakistan should allow the free movement of people, goods, and commodities between Pakistan and the part of Kashmir India occupies. The most appropriate way of achieving this would be in the context of the South Asia Free Trade Area, which, having become operational on January 1, 2006, is likely to evolve in terms of its scope and geographic coverage.[3] Third, India and Pakistan should become partners, so that they—along with a community of international and bilateral donors—might consider launching a massive program of economic development and reconstruction on both sides of the border. Although the program suggested in this study would cost $20 billion over a ten-year period, it would roughly double the state's gross domestic product growth rate to 9.5 percent a year, significantly reduce the pool of poverty, and better integrate the economies of the two parts of the state with Pakistan and northern India, respectively. This, in turn, would set the stage for the ultimate resolution of this long-standing conflict.

PREFACE

In the summer of 2004, the Research and Studies Program (now the Center for Conflict Analysis and Prevention) at the United States Institute of Peace organized an event to explore various economic initiatives that could in principle lay the groundwork for peace in Kashmir over the long term or at least provide relief to the inhabitants of the various disputed areas. Wajahat Habibullah, Vijay Sazewal, Teresita Schaffer, and myself participated in this event. Ambassador Schaffer graciously previewed some of the ideas that formed the basis of her recent publication titled *Kashmir: The Economics of Peacebuilding* (Washington, DC: Center for Strategic and International Studies, 2005), while Wajahat Habibullah, then a Jennings Randolph Fellow at the Institute, presented some of his research that explored the political economy of the Kashmir conflict and opportunities for economic peacebuilding there. (See Wajahat Habibullah, *The Political Economy of the Kashmir Conflict: Opportunities for Economic Peacebuilding and for U.S. Policy,* Special Report No. 121 [Washington, DC: United States Institute of Peace, June 2004].) After an evaluation of the various presentations at this 2004 meeting, Research and Studies believed that there was tremendous scope to flush out in greater depth the various economic aspects of the ongoing Kashmir discord. This study was commissioned by them with an eye toward building upon and expanding on the works of Schaffer and Habibullah. The reader alone can judge the extent to which I have filled this charge. I also wish to thank the four anonymous reviewers who offered numerous helpful suggestions for revision. Any errors or omissions, however, are my own.

1 INTRODUCTION

The Kashmir conflict has now endured for more than a decade and a half and has claimed between 30,000 and 50,000 lives.[4] Most of the lives lost were in the brutal warfare that did not distinguish combatants from noncombatants. As a result of this prolonged conflict, the state's economy has suffered. For a decade and a half Kashmir has been one of the slowest growing regional economies in South Asia. Today it is among the poorer states of India. In 2000–01, for example, it was the sixth poorest state in India in terms of per capita income (see table 1). Data on aggregate growth rates and per capita gross domestic state product (GSDP) and net domestic state product similarly indicate that—at least since the early 1980s—the state has performed considerably less well than India as a whole (see tables 2–4).[5] In fact, no matter which series of economic data is used, Kashmir is among the bottom one-third of the Indian states. This is not surprising, given the intensity of the insurgency over the past decade and a half.

Unlike India, Pakistan does not produce estimates of provincial products, and the data on economic activities in the part of Kashmir it administers are sparse and sketchy (see table 5). As part of my ongoing work on the economic history of Pakistan since the country gained independence, I am attempting to fill in several data gaps.[6] One part of this statistical exercise is to develop a production function for the districts of Pakistan using the quality of land (irrigated or rain-fed) and quality of the workforce (proportion of the population working, years in school) as determinants of growth and income. The district data are assembled into ten regions rather than four provinces and Kashmir. These regions are more economically homogenous than the provinces, and gross national and domestic product are more evenly distributed. According to these estimates and this line of analysis, per capita income of the area administered by Pakistan was 86 percent of the national average in 1990 but slightly higher than the national average fifteen years later. There are two possible reasons for this relatively better performance. First, a large number of Kashmiris have migrated over the past half-century and are working in Britain and North America or have relocated to Pakistan's major cities.[7] The government of Pakistan estimates that more than a million Kashmiris are working outside and remitting $500 million a year to their families and dependents. This level of remittance is equivalent to slightly less than a fifth of the gross regional product. Second, Kashmir, because of the structure of its economy, has a lower incremental capital output ratio than the average for Pakistan. In other words, the same amount of capital investment would produce a higher rate of growth.[8]

I contend that any process that ultimately resolves the Kashmir impasse will involve changing the way the Kashmir problem is viewed from both sides of the India–Pakistan border and within Kashmir itself. I hope to contribute to this reframing of the problem by first estimating the costs already borne by the parties engaged in the conflict. One of the innovations of this study is the introduction of a new way of understanding the impacts of the conflict—namely, through broadly defined opportunity costs. My estimates suggest that these costs are much higher for Pakistan than for India. In discussing and estimating opportunity costs, I follow the "what if?" or contrafactual approach of historians and political scientists. In other words, I ask what would have happened to the Pakistani economy had it not spent so much on building up its military strength, had it continued to trade with India as it did before achieving independence, had it become an attractive area for foreign investment, and had domestic investors taken a longer view of its economic potential.

This study is composed of six sections: an introduction, four substantive sections, and a brief conclusion. Following this introduction, I provide an overview of the Kashmiri economy, emphasizing the weaknesses that have emerged as a result of the prolonged conflict in the area. I then provide estimates of the cost to the Pakistani economy of the conflict based on quantifying the likely impact of four counterfactuals, or "what ifs?" Next, I provide an overview of the evolving regional trading arrangement in South Asia involving eight countries of the region and also assess how this arrangement could be used to develop the region of Kashmir. I conclude by presenting a prospective plan for fostering peace in Kashmir within the SAFTA framework.

Table 1. Per Capita Income by Indian Province

	State	Per Capita Income 2000–01 (in Rupees)
1	Bihar	5,466
2	Orissa	8,547
3	Uttar Pradesh	8,721
4	Madhya Pradesh	10,803
5	Assam	11,357
6	Kashmir	12,399
7	Rajasthan	13,116
8	Manipur	13,213
9	Tripura	14,348
10	Meghalaya	14,510
11	Arunachal Pradesh	14,587
12	West Bengal	16,072
13	Sikkim	16,143
14	Andhra Pradesh	16,373
15	Himachal Pradesh	18,920
16	Gujarat	19,228
17	Tamil Nadu	20,975
18	Kerala	21,310
19	Maharashtra	23,726
20	Haryana	23,742
21	Punjab	25,048
22	Goa	45,105
23	Karnataka	180,413
24	Chhattisgarh	—
25	Jharkhand	—
26	Mizoram	—
27	Uttaranjal	—

Source: Government of India, *Census of India, 2001, New Delhi, 2003*.

Table 2. Annual Compound Growth Rate in GSDP in Indian States, 1980s and 1990s (percent per annum)

GSDP at 1980–81 Prices 1980–81 to 1993–94		GSDP at 1993–94 Prices 1993–94 to 2000–01	
States		**States**	
Sikkim	10.65	Pondicherry	13.76
Arunachal Pradesh	8.79	Chandigarh	9.60
Delhi	7.40	Goa	9.45
Nagaland	6.90	Sikkim	8.97
Maharashtra	6.57	Delhi	8.89
Rajasthan	6.24	Karnataka	8.24
Goa	6.12	Tripura	8.19
Tripura	6.10	Manipur	7.98
Haryana	6.01	West Bengal	7.12
Andhra Pradesh	5.75	Meghalaya	6.82
Karnataka	5.61	Rajasthan	6.80
Meghalaya	5.60	Himachal Pradesh	6.79
A & N Islands	5.52	All India GDP (CSO)	6.32
Tamil Nadu	5.51	Tamil Nadu	6.23
All India GDP (CSO)	5.35	Gujarat	6.16
All States GSDP	5.27	Maharashtra	5.92
Manipur	5.14	Haryana	5.73
Gujarat	5.13	All States GSDP	5.72
Punjab	5.12	Andhra Pradesh	5.46
Himachal Pradesh	5.06	Kerala	5.28

Table 2. continued

GSDP at 1980–81 Prices 1980–81 to 1993–94		GSDP at 1993–94 Prices 1993–94 to 2000–01	
States		**States**	
West Bengal	4.93	Punjab	5.07
Madhya Pradesh	4.68	Kashmir	4.79
Uttar Pradesh	4.61	Madhya Pradesh	4.29
Kerala	4.27	Uttar Pradesh	4.25
Orissa	3.82	Bihar	4.13
Assam	3.63	Nagaland	4.02
Bihar	3.53	A & N Islands	3.96
Kashmir	3.35	Jharkhand	3.56
Pondicherry	3.32	Orissa	3.27
Arunachal Pradesh	3.06		
Chhattisgarh	2.88	Assam	2.63

Notes:
CSO = Central Statistical Office

All States GSDP represents the summation of GSDP for all states at constant prices for individual years, and the compound growth rate has been estimated for them.

The growth rate in *All-India GDP (CSO)* represents the compound growth rate based on the CSO's estimates of GDP as per national accounts statistics.

All State Domestic Product measures at 1993–94 prices for the period 1990–91 to 1992–93 have been derived by a method of splicing using the available 1980–81 series.

Source: S. L. Shetty, "Growth of SDP and Structural Changes in State Economies," *Economic and Political Weekly,* vol. 38, no. 49 (December 6, 2003), 201–32.

Table 3. Annual Compound Growth Rates of Per Capita GSDPs in Indian States, 1980s and 1990s (percent per annum)

States	Per Capita GSDP at 1980–81 Prices (1980–81 to 1993–94)	States	Per Capita GSDP at 1993–94 Prices (1993–94 to 2000–01)
Sikkim	8.05	Pondicherry	11.65
Arunachal Pradesh	5.51	Goa	7.91
Goa	4.53	Tripura	6.84
Maharashtra	4.18	Karnataka	6.63
Tamil Nadu	4.10	Chandigarh	5.88
Rajasthan	3.67	Sikkim	5.64
Karnataka	3.67	Manipur	5.54
Andhra Pradesh	3.53	West Bengal	5.46
Haryana	3.50	Tamil Nadu	5.15
All India GDP (CSO)	3.17	Himachal Pradesh	4.96
Gujarat	3.17	Delhi	4.87
Punjab	3.14	Gujarat	4.48
Delhi	3.12	All India GDP (CSO)	4.32
Himachal Pradesh	3.10	Rajasthan	4.16
Tripura	3.08	Kerala	4.13
All States GSDP	3.08	Andhra Pradesh	4.12
Kerala	2.88	Maharashtra	3.82
West Bengal	2.69	All States GSDP	3.78
Meghalaya	2.63	Haryana	3.75

Table 3. continued

States	Per Capita GSDP at 1980–81 Prices (1980–81 to 1993–94)	States	Per Capita GSDP at 1993–94 Prices (1993–94 to 2000–01)
Nagaland	2.54	Meghalaya	3.23
Manipur	2.52	Punjab	3.10
Uttar Pradesh	2.33	Madhya Pradesh	2.25
Madhya Pradesh	2.25	Kashmir	2.21
Orissa	1.94	Uttar Pradesh	2.06
Assam	1.39	Orissa	2.03
Bihar	1.36	Jharkhand	1.77
A & N Islands	1.35	Bihar	1.33
Kashmir	0.78	Chhattisgarh	1.25
Pondicherry	0.28	Assam	1.00
		Arunachal Pradesh	0.56
		A & N Islands	0.37
		Nagaland	–1.12

Notes:
All States GSDP represents the summation of GSDP for all states at constant prices for individual years and the compound growth rate has been estimated for them.

Growth rate in *All-India GDP (CSO)* represents the compound growth rate based on the CSO's estimates of GDP as per national accounts statistics.

All SDP measures at 1993–94 prices for the period 1990–91 to 1992–93 have been derived by a method of splicing using the available 1980–81 series.

Source: Shetty, "Growth of SDP and Structural Changes."

Table 4. Annual Compound Growth Rates in NSDP in Indian States, 1980s and 1990s (percent increase)

Per Capita NSDP at 1980–81 Prices States 1980–81 to 1993–94		Per Capita NSDP at 1993–94 Prices States 1993–94 to 2000–01	
Sikkim	10.45	Pondicherry	14.80
Arunachal Pradesh	8.89	Goa	9.73
Delhi	7.86	Chandigarh	9.64
Nagaland	7.58	Delhi	9.01
Goa	6.78	Sikkim	8.88
Maharashtra	6.59	Tripura	8.42
Rajasthan	6.15	Manipur	8.30
Haryana	6.11	Karnataka	8.14
Tripura	5.89	Meghalaya	7.25
Andhra Pradesh	5.76	West Bengal	7.17
Karnataka	5.52	Rajasthan	6.79
Tamil Nadu	5.47	Himachal Pradesh	6.52
All India NDP (CSO)	5.25	All India GDP (CSO)	6.20
All States NSDP	5.19	Tamil Nadu	6.08
Punjab	5.17	Haryana	5.57
Meghalaya	5.04	All States NSDP	5.52
Gujarat	4.95	Maharashtra	5.46
A & N Islands	4.90	Andhra Pradesh	5.46
Himachal Pradesh	4.87	Gujarat	5.30

Table 4. continued

Per Capita NSDP at 1980–81 Prices States 1980–81 to 1993–94		Per Capita NSDP at 1993–94 Prices States 1993–94 to 2000–01	
Manipur	4.87	Kerala	5.06
West Bengal	4.80	Punjab	4.88
Uttar Pradesh	4.51	Kashmir	4.57
Madhya Pradesh	4.28	Madhya Pradesh	4.20
Kerala	4.05	Uttar Pradesh	4.01
Orissa	3.49	Jharkhand	3.98
Assam	3.38	Bihar	3.97
Bihar	3.33	A & N Islands	3.55
Pondicherry	2.83	Arunachal Pradesh	2.76
Kashmir	2.60		
Orissa	2.53		
Assam	2.44		
Chhattisgarh	2.05		

Notes:
All States GSDP represents the summation of GSDP for all states at constant prices for individual years and the compound growth rate has been estimated for them.

Growth rate in *All-India GDP (CSO)* represents the compound growth rate based on the CSO's estimates of GDP as per national accounts statistics.

All SDP measures at 1993–94 prices for the period 1990–91 to 1992–93 have been derived by a method of splicing using the available 1980–81 series.

Source: Shetty, "Growth of SDP and Structural Changes."

Table 5. Gross Domestic Regional Product in Pakistan, 1990 and 2005

	1990			2005				
	Population	GRP	Per Capita GRP	Population		GRP		Per Capita GRP
				Millions	%	$b	%	$
Northwest Frontier Province	14.2	4.2	295	21.9	13.5	8.4	7.8	356
FATA	2.5	0.7	280	3.9	2.4	1.4	1.3	358
North Punjab	11.8	5.3	449	18.1	11.2	10.4	9.6	575
Central Punjab	33.7	16.4	487	48.4	29.9	36.5	33.7	754
South Punjab	13.9	6.8	489	20.9	12.9	11.5	10.6	550
Coastal Balochistan	1.4	0.6	429	2.3	1.4	1.3	1.2	565
Inland Balochistan	3.6	2.0	555	5.6	3.5	3.6	3.3	643
Urban Sindh	11.9	10.6	891	18.4	11.3	22.2	20.6	1,207
Upper Sindh	10.2	5.3	520	18.3	11.3	10.0	9.3	546
Azad Kashmir and Northern Areas	2.8	1.2	429	4.2	2.6	2.7	2.6	643
	106	53.1	501	162.0	100.0	108.0		642

Note: FATA = Federally Administered Tribal Areas.

Source: These are my estimates using land and labor productivity indices for different regions. I estimated the indices using (a) the quality of land cultivated (rain-fed or irrigated), (b) the quality and participation rates of labor (quality determined by the level of literacy), and (c) the level of urbanization. Punjab was divided into three regions; Sindh into two, urban and rural; and Balochistan into two, coastal and inland. The federal capital of Islamabad was included in North Punjab. These estimates were made as a part of my ongoing work on Pakistan's economic history.

2 HISTORICAL BACKGROUND: KASHMIR'S ECONOMY

In 1947, at the time of the birth of India and Pakistan, the state of Kashmir had a population of four million people, most of it concentrated in the fertile valley of the Jhelum River of the Indus River system. The Indus itself flowed through the northern areas of the state, with its mouth in the mountains in the undemarcated area between Kashmir and China. A number of major tributaries of the Indus either originated in the state or passed through it, collecting water from the melting snow in the high mountains in the area. With this abundance of water, it was natural that Kashmir would depend on agriculture for most of its income and for the livelihood of most of its population. Abundant water meant that Kashmir could practice more intensive agriculture than could the water-scarce Indian and Pakistani Punjabs, two areas that are contiguous to the two parts of the state. For the same reason, horticulture was more prevalent in Kashmir.

In the late 1940s, land was the main source of income for the state's citizens; it contributed 60 percent to the GSDP and employed 85 percent of the workforce. Although rice was the main crop and the staple food for the state's citizens, the area's abundant forests and animal husbandry provided important sources of income for a significant proportion of the population. Handicrafts, including woodworking and wool weaving, had a market not only among the tourists who visited the area but also all over British India. Two sectors—tourism and handicrafts—were important sources of external commerce for the state. These sectors were also the main "foreign exchange" earners for the area and gave Kashmir and its people a reputation for beauty and dexterity that traveled far beyond the state's borders.

The total population of the state has increased more than four-fold in the fifty-eight-year period since the departure of the British—a growth rate of 2.8 percent a year. Today, the largest number of people live in the valley, which also has the highest concentration of population. The area of Azad Kashmir, administered by Pakistan, is also very densely populated, with 331 persons per square kilometer. Ladakh, under India's control, and the Northern Areas, under Pakistan's control, are thinly populated. Almost one-third of the population lives in the areas administered by Pakistan (see table 6).

At the time of the partition of British India, the state had a population of slightly more than four million, one million of whom were in the areas that were occupied by Pakistan after the first Kashmir war of 1948–49. The remaining three million lived in the part of the state that was to be controlled by India. The population in the Indian part of Kashmir increased at a rate of less than 1 percent a year until 1971. After that year, the growth rate increased threefold to 2.6 percent a year (see table 7). It has stayed at that level for three decades, not showing the declines in fertility experienced in other parts of India. The sudden jump in the growth rate in the 1960s may reflect some migration into the area from other parts of India, a development resented by the native population of the state. Further, the coverage of the earlier Indian censuses in the state may have been less complete than those carried out in later years.

Table 6. Distribution of Population of Kashmir, 2005

Region	Administered by	Area (sq. km)	Population (million)	Density Persons/km
Kashmir Valley	India	15,900	6.0	377
Jammu	India	26,000	4.8	185
Ladakh	India	59,000	0.223	3.8
Azad Kashmir	Pakistan	13,300	4.4	331
Northern areas	Pakistan	72,500	0.9	12.4
Total		**186,700**	**16,323**	

Source: Author's projections based on the Indian (2001) and Pakistani (1998) censuses.

Table 7. Size and Growth of Kashmir's Population

Year	Population (million)	Growth rate, per annum
1941	2.971	
1951	3.254	0.9
1961	3.561	0.9
1971	4.617	2.6
1981	5.987	2.6
1991	7.804	2.6
2001	10.070	2.7
2005	12.845	2.6

Source: The data are from the censuses conducted by the government of India in the first year of every decade. The figure for 2005 is an extrapolation of the 2001 estimate using the average rate of growth of population in the period 1981–2001.

Additionally, the state's Hindu population in the two decades between 1961 and 1981 increased by 91 percent, while the Muslim population grew by only 58 percent, despite the lower birth rates among the Hindus (see table 8). This movement of Hindus into the state contributed to the tension between the two communities, although it was not the entire reason for the tension.

Table 8. Distribution of Religions in the Population of Kashmir (in millions)

Religious Groups	1961	% of total	1971	% of total	1981	% of total
Muslims	2.43	68.8	3.04	66.1	3.84	64.1
Hindus	1.01	28.5	1.4	30.4	1.93	32.2
Sikhs	0.006	1.4	0.1	2.2	0.14	2.3
Buddhists	0.005	1.3	0.06	1.3	0.07	1.4
Christians	0.001	0.9	0.001		0.001	
Jains	0.001	0.3	N/A		N/A	
Other						
Total	**3.54**	**100.0**	**4.6**	**100.0**	**5.99**	**100.0**

Source: Data provided by the Directorate of Economics and Statistics, Planning and Development Department, State of Jammu and Kashmir.

With population continuing to grow rapidly—at 2.6 percent a year compared with the Indian average of 1.9 percent—and with the GSDP increasing at only 3.4 percent, the incidence of poverty continued to increase. In 2002, more than a third of the state's population was absolutely poor, with an average income of less than a dollar a day. The incidence of poverty in the state is considerably higher than that in the neighboring parts of both India (the states of Punjab and Haryana) and Pakistan (the province of Pakistan). Poverty was prevalent in both rural and urban areas and among the youth. The unemployment rates have increased steadily in the part of the state under India's control since the beginning of the insurgency in 1989.[9]

Given the various constraints upon Kashmiris, many chose to migrate out of Kashmir during British rule. Kashmiris traveled far into India and settled in many distant places, including the United Provinces of British India and Delhi, the capital. However, most Kashmiris who left their state settled nearer home, in Punjab. They founded Kashmiri colonies in cities such as Amritsar, Lahore, and Sialkot that were not too distant from their homeland. Kashmiris now constitute an important segment of the Pakistani establishment (army, the civil service, and the political elite) and have retained significant cultural, linguistic, and political ties to their erstwhile homeland. Moreover, many Pakistani politicians have been Kashmiri, including Mian Nawaz Sharif, Pakistan's two-term prime minister, and General Khwaja Ziauddin, appointed by Sharif to succeed General Pervez Musharraf as chief of the army staff before Musharraf's military coup of 1999.[10] Famous Indian political figures have also been Kashmiri, including the Nehru family, and Jawaharlal Nehru's attachment to the region played a role in India's policy toward the state and contributed to India's unwillingness to implement the resolutions passed by the UN Security Council in 1949.[11]

As the state is mostly mountainous, little agriculturally usable land was available, which contributed to the growing poverty, particularly in the rural areas. Nevertheless, the economy continued to depend on agriculture as it had done for centuries. In 2000–01, agriculture accounted for close to a third of GSDP (see table 9). Rice remained the main crop, with some land devoted to wheat and corn. There were some changes in the composition of the economy in the nearly six decades since Kashmir became part of India. The two most significant were the direct product of the insurgency that began in 1989: trade and tourism lost their importance. As late as the early 1980s, these two activities accounted for 17.2 percent of the GSDP. Their share declined to less than one-tenth of the total by 2000–01. In 1980–81, forestry's contribution was estimated at 9 percent. Twenty years later, it had declined to only 3.3 percent. The unsettled conditions in the state and the government's inability to invest in the power sector put enormous pressure on its forestry resources.[12]

Table 9. Sectoral Composition of Kashmir's Economy, 1980–81 to 2000–01 (percent of GSDP)

	1980–81	1990–91	2000–01
Agriculture	37.8	35.0	28.9
Forestry	9.0	7.0	3.3
Other primary	0.8	0.6	1.0
Manufacturing	4.6	5.7	6.2
Construction	7.7	10.0	11.0
Other secondary	0.6	0.1	0.1
Trade and tourism	17.2	16.5	9.9
Real estate	9.2	3.6	11.5
Other	13.1	21.5	28.1
Total	**100.0**	**100.0**	**100.0**

Source: Planning Commission of India, Delhi, various reports.

In 2002, Kashmir's GSDP was $3.3 billion, equivalent to only 0.7 percent of India's gross national income of $495 billion. In the same year, the state had a population of 10.3 million or almost one percent of India's total population of 1.049 billion. The state's income per head of the population was $325 compared with India's average of $495. The state had a very low savings rate; the central government was the source of most of the government's revenues. As a special category state, Kashmir receives higher central government support for public sector investment compared with other regions. Ninety percent of this flow is provided as grants, the remaining 10 percent as loans. For other states, 30 percent of the central government's support for investment comes in the form of grants and 70 percent comes as loans.[13] Including central government support, the total amount of investment in the economy was no more than $400 million a year or 12 percent of the GDP in the early 2000s. This level of investment produced a small increase in the state's domestic product, estimated at Rs (rupees) 1,525 crores ($33 million), from Rs 5,745 crores in 1994–95 to Rs 7,270 crores five years later in 1999–2000. These estimates are in constant terms. In other words, total state product increased at an annual rate of only $6 million a year, or less than a dollar a year per citizen.

This brief overview of the economy of Kashmir suggests that unless a concerted effort is made to increase the level of investment and increase the rate of GSDP growth, the state's citizens will remain mired in poverty. As the remainder of this study argues, any resolution of the Kashmir problem will likely need to include a massive augmentation in investment in the region's economy.

3 ECONOMIC AND OTHER COSTS OF THE KASHMIR DISPUTE

Pakistan has paid a heavy price for its reliance on political Islam for the prosecution of its domestic and foreign policies. Fundamentalist interpretations of Islam have penetrated Pakistan's civil society. India has paid different costs for its own unwillingness to resolve the issue of Kashmir in a final and just manner. In recent years Islamist militants have attacked important targets in India, such as the Red Fort in New Delhi in 2000 and the Parliament compound in 2001. The latter attack brought India and Pakistan to the brink of war and again reminded the international community of the consequences of the dispute. More generally, the festering Kashmir dispute, once confined to the Himalayan area, now spills into the long-standing discord within India between proponents of Hindutva and the country's numerous Muslim communities.[14] While India clings tentatively to Kashmir to justify its national narrative as a secular, multiethnic, multireligious state, its unwillingness to settle this dispute puts at risk this very narrative.[15]

I believe that a fundamental element of creating "pressure for peace" involves informing the respective publics of Pakistan and India about the enormity of the direct and opportunity costs associated with the policies pursued by both capitals. Thus, it is useful to develop some estimate of these costs to inform the Pakistani people and its political establishment as to whether it was prudent to pay such a heavy price for this conflict. India also incurred costs, but not as high as those incurred by Pakistan. As Sumit Ganguly said in his recent *Foreign Affairs* essay, "a continued insurgency in Kashmir and poor relations with Pakistan will distract New Delhi, thereby imposing significant political opportunity costs. . . . The possibility of such a crisis might also deter investors."[16]

Because both governments tend to downplay the actual costs of the conflict and neither side even considers that there have been substantial opportunity costs, the public is scarcely aware of the magnitude and implications of the kinds of opportunities that have been sacrificed. Entering these notions of direct and opportunity costs into public debate may be an important step in cultivating constituents for normalization and in resolving outstanding disputes.

This study contributes to the debate over Kashmir by exploring the conflict's opportunity costs. Economic costs associated with the Kashmir conflict can be estimated by disaggregating the cost of the conflict and the likely benefits that would have resulted had the relations between the two countries been more amicable. This disaggregation can be done by estimating both the costs of high military expenditures and a decline in intraregional trade, particularly between India and Pakistan, and the potential benefits of a larger flow of foreign direct investment (FDI) and an investor-friendly domestic environment. As a result, the overall economic cost of the conflict can be estimated by posing a number of counterfactuals:

Counterfactual 1: What would Pakistan have spent on the military if its relations with India had not soured on account of the dispute over Kashmir? How would a lower military expenditure have affected the country's economy and its rate of economic growth?

Counterfactual 2: What would have been the benefit to the Pakistani economy had the two countries continued to trade with each other?

Counterfactual 3: How would Pakistan have benefited had foreign investors, who have begun to play an enormously important role in economic development with the advent of what economists call the process of globalization, not shied away from Pakistan on account of the rise of Islamist radicalism?

Counterfactual 4: The persistent problem of Kashmir has contributed to political instability in Pakistan, which in turn has affected its rate of economic growth. What would have been the impact of political continuity on the economy?

Before I proceed with an analysis of the results of this counterfactual treatment, a brief discussion of analytical methodology is appropriate. Of the four counterfactuals mentioned above, three—savings from smaller defense expenditures, larger flows of FDI, and larger domestic investments—would have likely led to greater amounts of capital flowing into the productive sectors of the economy. The impact these additional flows would have had on the rate of increase in Pakistan's GDP is estimated by using the capital output ratio for Pakistan for the entire period of 1947–2005.[17] As for the fourth counterfactual—larger trade between India and Pakistan, which in turn would have contributed to increasing the trade-to-GDP ratio for Pakistan—the impact on GDP growth is estimated by using the trade-to-GDP elasticity ratio for the country. This estimates what one additional percentage point increase in trade would likely contribute to growth in GDP.

There is little doubt that in the absence of the Kashmir dispute, military expenditure as a proportion of GDP would have been less for Pakistan than for India. Small countries in the neighborhood of large states tend to spend less on defense if their relations are cordial. In 2002, Argentina, for instance, spent only 1.1 percent of its GDP on defense, compared to 1.6 percent for Brazil. For Canada the proportion was only 1.1 percent compared with 3.4 percent for the United States. Even Bangladesh, which has uneasy relations with India, its much larger neighbor, spent only 1.1 percent on defense.[18] If Pakistan had spent 2.5 percent on defense—a proportion roughly equivalent to that of India—it could have saved as much as 3 percent of GDP a year. Compounded over the length of the conflict, the amount saved is equivalent to four times the country's current GDP. What would have been the consequence if this entire amount had been invested in the economy? Assuming that the rate of return would have been the same as that realized from investments in the past, additional capital flows into the economy would have significantly added to the country's economic growth rate. Put another way, military expenditure maintained at a level of 2.5 percent a year with the savings utilized at an incremental capital ratio of four—which means that investment equal to 4 percent of GDP raises the rate of GDP growth by 1 percent—would have increased the long-term GDP growth rate by as much as 0.75 to 0.85 percent a year. This addition to the rate of GDP growth compounded over 55 years would have meant an increase of more than 50 percent in the size of the GDP.[19]

Although a smaller amount committed to military expenditure would have directly contributed to increasing GDP growth, conflict with India also hurt Pakistan by reducing trade as a proportion of its economy. India's initial antipathy toward Pakistan was not the result of the Kashmir dispute. The first generation of Indian leaders—in particular, Jawaharlal Nehru, the country's prime minister, and Sardar Vallahbhai Patel, the powerful interior minister in the first Indian cabinet—were angry at Muhammad Ali Jinnah, Pakistan's founding father, and his political associates. Jinnah and his colleagues stood in the way of the realization of the Hindu leadership's dream of a united India—the achievement of the Hindutva dream. The Indian leaders were also convinced that they could get Pakistan to return to the Indian fold by increasing the economic cost of separation.[20] It was for this reason and not because of Kashmir that India launched its first trade war against Pakistan in 1949. However, the Kashmir situation later caused relations between the two countries to worsen and progressively loosened the strong economic links that had existed between the two parts of British India before they became independent states. During the British rule of India, the administration in New Delhi invested large amounts of resources to turn the provinces of Punjab and Sindh into granaries for the food-deficit provinces of Bengal, Bihar, and Orissa. In the 1940s, some 60 percent of the exports—mostly foodgrain and cotton—from the areas that now constitute Pakistan went to India. About the same proportion of Pakistan's imports came from India.[21]

Had the two countries continued to trade at pre-independence levels,[22] the rate of increase in Pakistan's international trade would have been on the order of 8 to 10 percent a year, rather than the average 6 percent achieved over the past twenty-two years. This increase clearly would have contributed to the GDP's growth. Indeed, economists maintain that there is an "overall relationship between trade and productivity (the trade-productivity elasticity): A 1 percent rise in the ratio of trade relative to GDP is associated with a 0.5 percent rise in GDP per capita over a period of one to two decades."[23] With the relationship posited above, it would not be an exaggeration to suggest that by maintaining trade with India at the levels of the late 1940s, Pakistan would have added another one-third to one-half a percentage point to its GDP increase. This would have meant an additional one-third increase in its current level of GDP.

The other important outcome of normalized relations with India would have been a greater flow of FDI into the country. The contribution of large FDI flows to the development and modernization of the economies of East Asia is now well recognized. South Asia has not benefited from the increased availability of these flows in large part because of the security problems associated with the Kashmir conflict. There were other reasons as well for the region's relative economic isolation—among them the less open economic policies followed by the countries in South Asia for nearly four decades. However, even when these policies were abandoned in favor of greater openness—as they were in the early 1990s—foreign capital did not become an important component of investment. This is particularly true of Pakistan.[24]

Better relations with India and more intraregional trade would have brought additional FDI into Pakistan, adding significantly to its relatively low levels of domestic savings and domestic investments. In 2002, Pakistan received $823 million FDI compared with India's $3 billion. Both countries did poorly in that area compared with those in East Asia. For instance, Malaysia received $3.2 billion, Thailand $2.4 billion, South Korea $2.0 billion, and the Philippines $1.1 billion.[25] Foreign investors stayed away partly because of the less open economies of the region but also because of the virtual absence of intraregional trade and because of security concerns. In the absence of these concerns, India and Pakistan could have attracted $10 billion a year and $2 billion a year, respectively. Two billion dollars of foreign flows would be equivalent to 3 percent of Pakistan's GDP.[26]

Pakistan also would have benefited from cross-border investments within the South Asian region had it maintained good relations with its neighbor. Large Indian corporations are now investing abroad but are reluctant to do so in Pakistan, because they are still not confident that the current thaw will persist. Other South Asian countries are now benefiting as India's corporate sector reaches out to them. In early November 2005, for instance, India's Tata Group unveiled Bangladesh as the beneficiary of its largest FDI—"an outlay so big it could match in value the country's total current stock of FDI." Tata's plans to invest $2.5 to $3.0 billion in Bangladesh for the production of steel and fertilizer and to generate electricity from the country's abundant but untapped coal reserves "could add 1.9 percent to nominal gross domestic product growth."[27] Good relations with India should attract Indian corporate interest in Pakistan.

Pakistan has had a long history of poor domestic savings rates, which translate into low rates of investment unless foreign capital is available. While domestic savings increased from 11 to 13 percent from 1990 to 2002, gross capital formation declined by four percentage points, from 19 to 15 percent of GDP. The 8 percent savings–investment gap was covered by foreign flows in 1990; the decline in foreign flows brought investment closer to domestic savings by 2002. Had foreign private capital been available in 2002 to the extent suggested above—in the neighborhood of $2 billion a year—this would have brought investment back to the levels of the late 1980s. Foreign flows amounting to about 3 percent of GDP would have added about 0.75 percent to the country's rate of economic growth.

At the height of the insurgency in Kashmir in the 1990s, a serious investment gap emerged between Pakistan and India. According to a study by Ijaz Nabi and his associates at the World Bank, private investment in India and Pakistan was about the same from 1982 to 1991. However, from 1992 to 2001, private investment in Pakistan was six percentage points lower than in India.[28] If a proportion of this gap—say about 75 percent—is attributable to the deterioration of the investment climate in Pakistan caused by the rise of Islamist militancy in the country, then we can infer that this development alone led to a loss in growth of at least one percentage point of GNP. Stable relations with India would have brought economic and perhaps also political stability to Pakistan, which would have produced a better investment climate in the country and contributed to higher levels of domestic savings and investment. Stability would have also contributed to increasing the rate of GDP growth.

Aggregating the four positive consequences for the Pakistani economy had Pakistan resisted involvement in the Kashmir dispute shows that its long-term growth rate could have been some 2.25 to 3.2 percentage points higher than that actually achieved (see table 10). A growth rate of this magnitude sustained over half a century would have increased the country's gross product by a factor of between 3.4 and 4.4. Indeed, had the country been at peace with India over the past decades, Pakistan's 2003–2004 GDP could have been three and a half times larger than it was—$330 billion rather than $95 billion—and its income per capita could have been $2,200 rather than $630. These estimates, of course, are very rough. They are based on a series of heroic assumptions about the efficient use of resources diverted from military to development expenditure; about a significant increase in trade with India and a higher level of trade contributing to economic growth; about Pakistan becoming an attractive area for FDI; and about domestic savings and investment increasing with tranquility in the region. Even if half of the benefits estimated above had been actually realized, though, they would have changed the economic, political, and social complexion of Pakistan.

Table 10. Economic Losses Caused by the Kashmir Dispute

Cause	Growth Forgone (% per year)
High expenditure on the military	0.75–0.85
Reduction in intraregional trade	0.3–0.5
Larger flow of foreign direct investment	0.75–0.85
Larger amounts of domestic investment	0.75–1.0
Total	**2.25–3.20**

Source: Author's estimates, as detailed in the text.

In sum, a good case can be made that Pakistan has paid a very heavy economic, social, and political price for continuing to keep the Kashmir case on the front burner. Indeed, this is a good time for the country to take a hard look at the cost–benefit calculus of its Kashmir policy. Unfortunately, currently available data do not suggest that Pakistan has taken steps toward doing so.

That said, it is difficult for countries to bring about dramatic changes in long-held positions. President Musharraf's "U-turn" on the Taliban came about only because of global hostility to the regime that controlled Afghanistan at the time of the September 11, 2001, terrorist attacks on the United States and because of clear pressure from the Bush administration.[29] No similar pressures exist in the case of Kashmir other than the realization by President Pervez Musharraf and his associates that there are links between the continuation of the dispute, the rise of Islamist extremism in the country, and the threat that the groups espousing jihad as a state policy pose to the country.[30]

Table 11. Military Expenditures in India and Pakistan, 1992–2002

	India	Pakistan
Population, 1992 (m)	869	113
Population, 2002 (m)	1,049	145
GDP, 1992 ($b)	282	43
GDP, 2002 ($b)	495	61
Military expenditure, 1992 ($b)	6.49	2.8
Military expenditure, 2002 ($b)	12.87	2.5
Armed forces (000)	1,270	580
Armed forces (000)	1,300	590
Expenditure per soldier, 1992 ($m)	5.1	4.8
Expenditure per soldier, 2002 ($m)	9.9	4.2

Source: Estimated from the data in the World Bank, *World Development Indicators* (Washington, DC, 2004), table 5.8, 283.

4 SOUTH ASIAN REGIONAL INTEGRATION AS A FRAMEWORK FOR SOLVING THE KASHMIR PROBLEM

This section builds a case for using trade within a regional arrangement as a way to develop the Kashmiri economy and to create pressure for peace on both sides of the border. The inauguration of the South Asia Free Trade Area (SAFTA) provides an opportunity for India and Pakistan to facilitate trade with Kashmir by removing barriers to trade and to ease the movement of people across the Line of Control.

Economies of the South Asian Region

The seven members of the South Asian Association for Regional Cooperation (SAARC) had an estimated population of 1.3 billion in 2002 and a combined GDP of $640 billion measured at market exchange rates or $3.4 trillion in terms of purchasing power parity (PPP). This is a relatively poor region, with average per capita income of only $466 in conventional terms and $2,493 in PPP terms (see table 12).

Table 12. Macroeconomic Data for the SAFTA Countries, 2002

	Population (thousands)	GDP, PPP (current int'l $m)	GDP (current US$m)	Per capita income (PPP)	Per capita income (current US$)	Total Trade (US$m)	Trade % of GDP
Bangladesh	135,684	229,995	47,563	1,695	351	15,849	33
Bhutan	851	—	591	—	695	358	61
India	1,048,641	2,810,987	510,177	2,681	487	157,242	31
Maldives	287	—	641	—	2,232	970	151
Nepal	24,125	33,344	5,494	1,382	228	2,462	45
Pakistan	144,902	281,270	59,235	1,941	409	22,347	38
Sri Lanka	19,007	67,668	16,567	3,560	872	13,093	79
South Asia	1,373,497	3,423,264[a]	640,268	2,493[a]	466	212,321	33
Low Income	2,269,705	4,697,081	197,781	2,070	418	416,358	46

[a] Excludes Bhutan and Nepal

Source: The World Bank, *World Development Indicators 2004.*

By way of comparison, China in 2002 had a population of 1.280 billion, slightly less than that of South Asia. However, its GDP in both conventional and PPP terms was considerably higher: \$1.234 trillion and \$5.792 trillion, respectively. China's GDP per capita, estimated at \$960 at market exchange rates, was almost twice that of South Asia. In PPP terms, income per head of household (\$5,792) was 2.3 times larger than that in South Asia.[31] There is now broad consensus among China scholars that the open trading system adopted by the country after it began to reform its economy in the late seventies has helped it to achieve and maintain high growth rates in its GDP. The South Asian region has been considerably less open than China. This is one of several reasons why South Asia has done much less well than China over the past quarter century. In 2002, China had a trade-to-GDP ratio of 75 percent, whereas that of South Asia was only 33 percent. There is little inter-regional trade (see table 13). As discussed in section 3, the problem of Kashmir has contributed to the sharp reduction in intraregional trade over the past half century. Finding a solution to the problem will undoubtedly have a significant economic impact across the region.

South Asia and the New International Production System

Despite India's impressive gains over the past decade in becoming a major world player in the rapidly expanding sector of information and communication technology, South Asia as a region remains poorly integrated into the evolving global production system. There are essentially two reasons for this. First, an inwardly focused strategy of economic growth pursued by all countries of the region from the time of their birth as independent states to the early 1990s, when India—and to a lesser extent Pakistan—was hit by serious foreign exchange crises, has kept South Asia isolated. This strategy was adopted because of the economic philosophy subscribed to by the first generation of the region's leaders, in particular those who led India during its formative years. Jawaharlal Nehru was the most dominant voice among this group of leaders. He was particularly impressed with the Soviet model of central planning that placed the state at the head of the economy and emphasized rapid industrialization by developing such producer goods industries as steel, ironworks, and machine building.

Second, the other reason for the South Asian countries' willingness to lock themselves behind walls of protection and to remain oblivious to the changes occurring around them was the deep hostility that developed between India and Pakistan virtually from the moment of their birth. Had the two countries maintained good relations, they might have learned to deal with the world outside and to look beyond their immediate borders. Continuing antagonism between the two countries contributed to the region's isolation until the early 1990s. Even to this day, the region has not fully opened itself to the outside. This failure has resulted in considerable economic loss for the region.

In the past four decades, developing countries have carved out a prominent role for themselves in the evolving global production system and in world trade. These two developments are closely linked. The evolving international system of production is based on the activities of some 60,000 corporations that have spread their production facilities to many parts of the world. These companies—the United Nations Conference on Trade and Development (UNCTAD) calls them transnational corporations (TNCs)—have gone into regions that offered a welcoming environment. The "global production system"—another UNCTAD term used in their annual *World Investment Reports* to describe the way a large number of American, Western European, and Japanese firms have evolved into TNCs[32]—now encompasses a number of less developed East Asian countries. South Asia is largely absent from the field, even though the TNCs have located their production facilities in many countries and in many continents. The choice of location is dictated sometimes by the fiscal environment in which they have to operate. But most of the time location is determined by factor endowments and the environment offered by the host country.[33] The South Asian environment lacked a sense of security largely because of the tension created by the Kashmir dispute.

By splitting the final product into several intermediate products and components, TNCs maximize returns on their investments. They are able to play on various kinds of arbitrages—wage, skill, and knowledge being the most important—by locating the manufacture of parts and components in the countries that have the comparative advantage in producing them. These components are then sent for assembly into final products and shipped to customers all over the globe. The East Asian countries have become major suppliers of these parts and components. This is one reason why China now runs a sizeable trade deficit with the countries of East Asia and has a large trade surplus with the United States.

With this system of production in place, much international trade takes place within firms. The direction of trade is also profoundly influenced by this system. This is one reason why the developing world's share of world trade increased from about one-fifth in 1960 to about one-third in 2004.[34] This increase happened while international trade as a whole was growing at unprecedented rates. In every world region, growth in exports outpaced growth in output. In the developing world, the East Asian region outperformed the rest. Latin American exports also grew as a share of the world market in the 1990s. The South Asian region (SAR), on the other hand, did relatively less well. Although the region's GDP growth in 1980–2000 and its share of exports in output also increased—particularly in the latter part of this period—it had the lowest share of trade in the aggregate GDP of any region barring the Middle East and North Africa. Non-oil export shares of the East Asia and Pacific region increased from 18 percent in 1980, to 25 percent in 1990, to 34 percent in 2000. The corresponding shares for the SAR were 8, 8.5, and 14 percent, respectively.

There are several reasons why South Asia has done poorly in terms of becoming better integrated into the global economy. One of the more important reasons is its failure to draw foreign companies into the region as both investors and traders. TNCs set up operations where they see a large domestic market; a well-developed workforce; reasonable physical infrastructure that ensures uninterrupted supplies of electricity, gas, and water; security for the lives of both the expatriates who come in with these ventures and the people they employ; a sound financial system; and legal and judicial systems that can resolve contract disputes.[35]

Table 13. Direction of Exports from the SAFTA Countries (percent of total)

Destination	Bangladesh	Bhutan	India	Maldives	Nepal	Pakistan	Sri Lanka
United States	36	3	21	38	29	29	38
United Kingdom	11	3	5	10	2	9	13
Germany	12	<1	4	3	8	6	4
China	1	<1	4	—	—	7	—
France	7	2	2	0	1	4	2
India	1	91	—	<1	49	0.5	4

Source: U.S. International Trade Commission, COMTRADE Statistics 2004, Washington DC, 2004, Various tables.

The main question addressed in this study is whether formal regional integration would reverse this trend. The Islamabad declaration issued by the leaders of the member states of the SAARC after the conclusion of their summit held in Islamabad January 4–6, 2004, has set into motion a process that may culminate in the creation of a free-trading area in South Asia. Would this result in improving South Asia's economic performance and integrate the region into the global economic system? Should the success of the proposed SAARC be measured only in economic terms? Could the proposed SAFTA provide a framework within which the economies of the two parts of Kashmir could be firmly embedded within the economies of India and Pakistan? Could such a subregional arrangement be the first step toward greater economic cooperation between India and Pakistan?

Even at this early stage of analysis of the possible outcome of SAFTA and its impact on the economies of the region, it is important to underscore that SAFTA's success will depend on noneconomic outcomes. Robin Cook, former foreign minister of Great Britain, has articulated very well the contribution regional integration can make to regional peace: "Pause for a while to contemplate the remarkable transformation of European politics which made this event (the signing of the European Constitution in October 2004) possible. Most of the countries sitting together in the same council chamber have been at war with each other in living memory and in the century that preceded it." But as he further states, the progress toward increasing economic and political association among the countries of Europe was not always easy: "Their appeal to past millennium betrays what derives their resistance to European integration—a misplaced nostalgia for the outdated world of free standing nations. It is an era that has vanished. We are all interdependent now."[36]

Could a regional trading arrangement in South Asia such as the one envisaged under SAFTA set in motion the same kind of dynamism that has brought Europe to its present situation?

The answer will depend in part on how the SAFTA countries shape the agreement. They could adopt a very narrow approach and create a trading arrangement in the region that does little to bring out South Asia into the global economy as a vigorous partner. That would be the case if the seven countries engaged focus on their narrow national interests and not on the broader issues of the role of South Asia in the global economy or on laying a framework within which some of the long-standing disputes among the states—such as the problem of Kashmir—could be resolved.[37] If the latter approach were adopted, some political figure like Robin Cook might say something similar a few decades from now.

Why has South Asia struggled so hard to develop a truly regional economy? Why is it the only major region in the world in which the gravity model of trade does not apply? According to the gravity model, the flow of trade is determined by the size of the trading economies and the distance between them. Countries close to one another should trade more among themselves than with distant countries. This is not the case in South Asia.

History as a Determinant of the South Asian Malaise

Poor regional integration in South Asia has been the result of many circumstances, the most important of which has been, of course, the intense hostility between India and Pakistan. This hostility dates back to the time when the two countries gained independence from colonial rule in 1947. It is only now, following the SAARC summit of 2004 and the meeting on the summit's sidelines between Musharraf and then Indian prime minister Atal Bihari Vajpayee, that the relations between the two countries have begun to thaw. Although some warming has occurred, there is still a long way to go before history's legacy can be overcome. That noted, the successful implementation of SAFTA could play a role in improving relations between these two longtime rivals. It could also provide the framework within which the Kashmir problem could be addressed.

Successful implementation of SAFTA would also help to restore health to the South Asian economy by removing some of the distortions that resulted from the partition of British India into the independent states of India and Pakistan and the subsequent division of Pakistan in 1971. The latter event resulted in East Pakistan, the eastern wing of original Pakistan, gaining independence as Bangladesh. Under colonial rule, most of the SAR was one country with an integrated economy, with much of the physical infrastructure built specifically to allow the easy flow of goods and commodities among the provinces of British India. The re-creation of such an economy could contribute significantly to the solution of the Kashmir problem and to the integration of the state, which has become increasingly isolated, as vividly illustrated by the aftermath of the October 8, 2005, earthquake. Both the Indian and Pakistani parts of Kashmir are now in an economic cul-de-sac, cut off from the rest of the world. A subregional arrangement centered around the two parts of Kashmir, therefore, would certainly result in the rebound of the state's economy, providing additional employment opportunities to the region's young population, reducing the incidence of poverty, and relinking the area with the larger South Asian and global economies.

Such an arrangement could be devised independent of SAFTA, which was formally proposed at the twelfth SAARC summit held in Islamabad in January 2004 and formally launched in November 2005 at the thirteenth summit held in Dhaka. Just as India and Pakistan have found it difficult to negotiate Kashmir as a stand-alone problem, preferring to make it part of a "composite dialogue" involving a number of other outstanding issues, so too may crafting a separate subregional trading arrangement be politically difficult. Making it a part of SAFTA, however, is certainly feasible.

To properly envision how the two regions of Kashmir could be fused into one economic system with the rest of Asia, with benefits accruing to all, one must first consider a specific part of the region's history. In the latter part of the nineteenth century and the early part of the twentieth century, India was repeatedly ravaged by famines. According to the British historian Niall Ferguson, "Another famine [after the one in 1780] in 1783 killed more than a fifth of the population of the Indian plains; this was followed by severe scarcities in 1791, 1801, and 1805."[38] The enormous loss of life caused by the famines created great anxiety in India Office in London. A number of blue-ribbon Royal Famine Commissions were established to devise a long-term solution to the problem of persistent food scarcities. Eventually a strategy was adopted aimed at increasing the domestic supply of food grains in India.

The British planners saw an opportunity in the vast tracts of virgin land in the provinces of Punjab and Sindh. This land could be put under the plough by bringing to it irrigation water from the well-endowed Indus river system. The strategy worked, and within a few decades, Punjab and Sindh were able to produce vast quantities of food grains surplus. But this surplus had to be transported to the food-deficit areas in India's northeast, particularly to the heavily populated provinces of Bengal and Bihar and the eastern United Provinces. To do this, the British made large investments in transport infrastructure, particularly in a system of farm-to-market roads connected with the fabled Grand Trunk Road that linked Kabul with Calcutta and was originally constructed by Emperor Sher Shah Suri in the early sixteenth century. The British administration also invested in railways and the port of Karachi. These investments in irrigation and transport infrastructure laid the basis for the close economic integration of the various areas of the British Indian Empire, which are now parts of the independent states of Bangladesh, India, and Pakistan. But this well-developed regional infrastructure fell into disrepair as a result of the conflict between India and Pakistan. Even the Indian state of Punjab came to depend on the distant ports of Bombay and Calcutta to export its surplus food grains and to import some significant agricultural products.[39]

However, Kashmir has suffered the most from the severance of communication links between India and Pakistan. The roads connecting Srinagar in Kashmir with Rawalpindi in the Pakistani part of Punjab and Jammu in the state's south with Sialkot, also in Pakistan's Punjab, were the main links connecting Kashmir with the outside world. Entirely new links had to be created once the Kashmir dispute closed the border between the two parts of the state. These new links connected Kashmir with India and redirected the state's economy in an entirely different direction.[40]

If SAFTA succeeds in its aims, over the next decade it should be able to restore the economic and trading system that existed before British India was divided into several independent countries. It could also reestablish the once vibrant communication links, especially between the two parts of Kashmir. The state could once again benefit from the natural links with today's Pakistan. Easing of tensions between India and Pakistan would also help to revive the historical trade links between Kashmir and China (the old silk route passes through Pakistan). It was politics that severed these links; it will take politics to restore them.

Politics intervened most dramatically in the way the waters of the Indus River system were divided between the successor states of India and Pakistan. The water dispute surfaced in the early 1950s and almost led to another war between the two countries. It took intense international diplomacy and the involvement of a consortium led by the World Bank to save the situation. An agreement—the Indus Water Treaty of 1960—was reached that led to the assignment of three western rivers of the system (the Indus, the Jhelum, and the Chenab) to Pakistan and three eastern rivers (the Ravi, the Sutlej, and the Beas) to India.[41] While the Indus Water Treaty helped to solve the problem between India and Pakistan by finding an equitable way to share water that flowed through the system, it had negative consequences for Kashmir.[42]

This was not the only dispute between India and Pakistan that had profound economic consequences for the South Asian region. The 1947 partition of British India into India and Pakistan need not have resulted in the sharp decline in trade between these two new entities. This decline happened mostly for political reasons. In 1949 Pakistan refused to follow the other countries of what was then called the Sterling Area and to devalue its currency with respect to the U.S. dollar.[43] India, in turn, refused to recognize the new exchange rate of 144 of its rupees to 100 Pakistani rupees and halted all trade with its neighbor. Pakistan, starved of most manufactured goods of daily consumption, launched a program of industrialization to achieve a measure of self-sufficiency. Had this trade war not occurred, Pakistan would not have industrialized as rapidly as it did and would not have forsaken its comparative advantage in agriculture.[44] Some of these developments could be reversed—with beneficial consequences for the South Asian economies—by the successful implementation of the proposed SAFTA along with a subregional arrangement involving Kashmir. Indeed, it should now be possible to take advantage of the new political dynamic that came with the signing of the Islamabad peace declaration in 2004 and to begin to resolve some issues that seemed intractable not too long ago.

The political problems between India and Pakistan were not the only reason for the poor performance of intraregional trade in South Asia, however. All countries in the region pursued import substitution approaches toward economic development for nearly four decades, from independence in the late forties to the adoption of greater openness in trade beginning in the mid-eighties. Consequently, following independence from British rule, trade among the South Asian countries fell from about 19 percent of total trade in 1948 to around 4 percent by the end of the fifties and to only 2 percent by 1967.[45] This low share began to increase only after individual countries in the region began to pursue general trade liberalization policies, with the share having increased to 5 percent in recent years (see table 14). As a comparison, however, intraregional trade accounted for 67 percent of the total for the European Union, 62 percent for North American Free Trade Agreement (NAFTA) countries, and 26 percent for the Association of Southeast Asian Nations (ASEAN). South Asia, in other words, has a long way to go before it can achieve the level of integration attained by other world regions.

Table 14. Officially Recorded Intraregional Trade as a Share of Total Trade, 1981, 1990, 1994, and 1998

Country	Intraregional Imports				Intraregional Exports				Total intraregional Trade			
	1981	1990	1995	1998	1981	1990	1995	1998	1981	1990	1995	1998
India	1.3	0.4	0.6	1.1	2.9	2.7	5.1	5.6	1.8	1.4	2.7	3.2
Pakistan	1.9	1.6	1.5	2.4	5.5	4.0	3.2	4.9	3.1	2.7	2.2	3.6
Bangladesh	4.7	7.0	17.7	17.5	7.9	3.1	2.3	2.7	5.4	5.8	12.7	12.4
Sri Lanka	5.2	7.0	11.4	12.9	8.8	3.7	2.7	2.4	6.5	5.6	7.5	8.2
Nepal	—	13.4	17.5	31.7	63.8	7.7	9.2	36.2	47.4	11.9	15.0	32.8
Maldives	6.0	7.4	4.5	7.7	22.3	13.8	22.5	16.6	9.4	9.2	6.7	9.4
Bhutan	N/A	10.9	57.5	59.9	N/A	9.6	87.9	81.9	N/A	9.7	73.5	71.8
South Asia	2.4	2.0	3.8	4.3	4.8	3.1	4.3	7.5	3.2	2.4	4.1	4.9

Notes:
N/A = not available

Shares for Bhutan are based on partner data (mirror statistics). There are discrepancies between FOB (Free on Board) and CIF (Customs Insurance and Freight) values in mirror statistics. The large decline in Nepal's regional trade in the early 1990s was due to the "trade and transit" crisis with India, during which India closed a number of key trade and transit points with Nepal.

Source: Estimated from International Monetary Fund Direction of Trade Statistics and reproduced from *Trade Policies in South Asia: An Overview,* World Bank Report #29949 (Washington, DC, 2004).

As briefly discussed earlier, history left one other legacy in South Asia that is pertinent to this study: the adoption of dirigistic economic policies by all countries in the region. It all started with Jawaharlal Nehru, who, taking the advice of a number of well-established economists but also following his own instincts, brought socialist economic management to his country. This was an easy step to take since India, as a result of the support it had provided to Britain in fighting the Second World War, already had a well-developed bureaucratic system that could quickly establish controls over the economy. During the war, the Indian bureaucrats were made responsible for setting up public sector enterprises for producing goods for the war effort that could not be obtained readily from the market. They were also responsible for procuring supplies for the fighting forces while ensuring that domestic shortages did not occur. To prevent price gouging, the bureaucrats ran an elaborate system of rationing and price controls. This bureaucracy and the elaborate systems it had devised were at hand when

Nehru launched what came to be called the "license raj." Developed over a period of three decades, this system left no corner of the Indian economy—old and established or new and modern—untouched.

For a decade and a half, Pakistan took a different route, encouraging the private sector to help meet the enormous shortages of consumer goods created by the 1948 trade war with India. While encouraging private entrepreneurship, the Pakistani state built a high wall of protection around it. It also established state-owned financial institutions to provide the private sector with cheap and long-term capital. And, for a time, Pakistan operated a dual exchange rate system that gave rich incentives to those who set up import-substituting industries and punished those who wanted to sell their products in the international market.

Between 1972 and 1974, Zulfikar Ali Bhutto, an avowed socialist, took the final step in socializing the Pakistani economy. Soon after assuming office, he undertook a program of extensive nationalization of private assets. His administration took control of thirty-one large-scale industries, virtually all financial institutions, all large-scale trading companies, and eventually even small agro-production enterprises. By the middle of the 1970s, the grip of the Pakistani state on the economy was as tight as the hold of the state in neighboring India.[46]

Looking at both India and Pakistan, Mujibur Rahman, the first president of Bangladesh, found no reason why he should experiment with a system of economic governance different from those followed by his neighbors. He also brought bureaucratic socialism to his country. Consequently, by about the mid-seventies, South Asia had closed itself off from the outside world. This was the time when several small countries of East Asia began to open their economies both to foreign trade and to external capital flows. These two entirely different approaches to economic management were to profoundly influence the economic fortunes of both East Asia and South Asia. The question then is whether the South Asians will be able to close the yawning gap that has developed between their economic situation and that of East Asia. How much of a role could regional integration play in rescuing South Asia?

The relatively poor performance of South Asia in terms of carving out a greater role for itself in international trade was due in part to the protectionist trade policies pursued by all countries in the region until recently. It was also the consequence, as already indicated, of the region's failure to develop an industrial structure that was well integrated into the international production system. The reason it was left behind had much to do with political difficulties between India and Pakistan and the protectionist trade policies pursued for more than four decades by the regional governments. This stance, fortunately, has begun to change. Will South Asia now get better integrated with open economies, allowing greater regional integration? Part of the answer will lie in the way the current leaders of India and Pakistan find a solution to the problem of Kashmir. It is not always recognized outside South Asia that the problem of Kashmir has not only deeply affected Pakistan and India, the former more than the latter, but has also taken a heavy economic toll on all of South Asia. It has fragmented the region. One manifestation of this are the many bilateral and subregional trading arrangements that now crowd the South Asian economic geography. Moving toward the resolution of the Kashmir problem by using trade as a glue to bind together the splintered region will help avoid the difficulties inherent to what—to mix metaphors—economist Jagdish Bhagwati calls the spaghetti-bowl approach to trade.[47]

As a result of some of the recent changes in trade policy in larger countries, the South Asian region is now reasonably open to international trade. In 2000, Sri Lanka was the most open country in the region with a trade-to-GDP ratio of 77 percent. The corresponding ratio for Nepal was 44 percent; for Bangladesh and Pakistan, 33 percent; and for India, 19 percent. The relatively lower figure for India is typical of most large countries with the exception of China. However, there is relatively little trade among the countries of the region.

From Autarky to Relative Openness in South Asia

First Sri Lanka and later India, Bangladesh, and Pakistan abandoned trade protectionism in favor of openness for development and poverty alleviation. Sri Lanka embarked on this course in the late seventies; it was subsequently taken by the four large countries of the South Asian mainland in the early nineties. India's move toward greater openness was prompted by the foreign exchange crisis in 1991 and by the prodding of the International Monetary Fund, which had by then developed a new approach that most commentators subsumed under the title of The Washington Consensus. Fiscal austerity, privatization, and market liberalization were the three pillars of this program of economic adjustment. According to Joseph Stiglitz, "the Washington Consensus policies were designed to respond to the very real problems in Latin America, and made considerable sense. . . . When trade liberalization—the lowering of tariffs and elimination of other protectionist measures—is done the right way and at the right pace, so that new jobs are created as inefficient jobs are destroyed, there can be significant efficiency gains."[48] Unlike some of the countries in Latin America, however, South Asian countries did not rush into the implementation of these policies. The pace adopted by South Asian governments was measured—at times too measured. Once again it was Kashmir that cast a deep shadow on economic policymaking.

Economic crisis was not the only reason for the adoption of greater openness as the strategy for promoting growth by South Asian countries. The regional governments also responded to the way development institutions such as the World Bank interpreted the remarkable performance of the "miracle economies" of East Asia.[49] The export-oriented growth policies adopted by these countries were widely credited for their phenomenal economic growth in the quarter-century before the Asian financial crisis of 1997. As one World Bank publication has noted, "Some analysts have, with hindsight, attributed these achievements to unique cultural and geographical circumstances. But there was little evidence at the outset that East Asian economies would achieve spectacular results. In the 1950s even trade optimists were export pessimists and did not anticipate that Korea's exports would grow four times as fast as world trade during the next thirty years."[50] In 1970, for example, Korea's trade-growth to GDP growth ratio was 0.32; it increased to 0.66 in 1988. For Malaysia, another miracle economy, the ratio in the same period increased from 0.89 to 1.09.[51] The East Asian economic miracle had a profound impact on the thinking of policymakers in South Asia. They were also prepared to accept openness in place of the discredited import-substitution policies pursued in the past.

From the mid-eighties to about the mid-nineties, most major economies of the SAR region undertook major reforms aimed at achieving greater openness. However, the effort stalled, particularly in India after 2000. Old habits die hard, and there were also strong vested interests that had survived the demise of the "license raj." These interests were prepared to mobilize political pressure to slow the process of reforms. But the reformers persisted. Liberalizing momentum ultimately resumed in India with large cuts in industrial tariffs between 2002 and February 2004. According to a recent World Bank study, "other developments—Pakistan's comprehensive liberalization of its trade policies since 1996/97 (including its agricultural trade policies), and Sri Lanka's potential to resume long-deferred reforms as prospects improve of ending its civil war—contribute to a regional picture of very mixed achievement but widely shared responsibility."[52] As a result of these measures, Pakistan and Sri Lanka are now the least protected markets in the region (see table 15).

While the regional governments were bringing down their level of protection, some of them also took steps to encourage intraregional trade. For example, since the SAARC was still stalled because of the continuing hostility between India and Pakistan, India took steps to increase trade with the smaller nations around its periphery and concluded a number of bilateral trading arrangements with its neighbors. As a consequence, regional trade expanded rapidly during the late 1980s and throughout most of the 1990s in terms of total value but not in terms of the proportion of total trade. This expansion was principally due to unilateral trade liberalization by the countries on India's borders and to large appreciations of the exchange rates of the peripheral countries relative to the Indian rupee. In fact, most of the increased trade was one way, with large increases in exports from India, especially to Bangladesh and Sri Lanka. This growth in regional trade had little to do with the grant of regional trade preferences, which were not very consequential in increasing intraregional trade.

Regional Trading Arrangements: Their Pros and Cons

If both India and Pakistan would support regional and subregional trading arrangements, would South Asia be bucking the trend toward greater multilateralism in trade? By opting for such an approach, would it be buying economic inefficiency in return for regional peace? There are no ready answers to these questions.

Among the three approaches to increasing trade among countries, purists prefer unilateral action not contingent upon grant of reciprocity by trading partners.[53] The second-best approach is to conduct negotiations on removing barriers to cross-border trade in the context of such "international rounds" as the Tokyo and the Uruguay discussions and the Doha discussions begun in 2001. The least satisfactory approach is to start with regional integration as the first step toward easing the constraints on global trade. Notwithstanding the disdain with which purists regard regional integration, such agreements have proliferated over the years, as has the literature analyzing their contribution to promoting international trade. The number of regional trading agreements (RTAs) has more than quadrupled since 1990, rising to around 230 by 2004.[54] Trade between RTA partners now makes up nearly 40 percent of total world trade.

RTAs have also become more ambitious in scope. New agreements, including those between developed and developing countries—or North–South agreements—are increasingly addressing issues that go beyond trade, such as investment, labor and environmental laws, and, in some cases, political openness. Nontrade issues have become particularly important as the value of preferences has steadily declined and as most countries have been reducing tariffs across the board on a most favored nation basis. Notwithstanding such North–North agreements as the recent expansion of the European Union to incorporate labor movements, most North–South and South–South agreements are confined to intrafirm movement of professionals, and neither substantially increases access for temporary workers, skilled or unskilled.

Most South–South agreements are focused primarily on merchandise trade, and tend to treat services, investment, and intellectual property rights unevenly or to ignore them altogether. Agreements such as ASEAN and MERCOSUR have not provided specifically for liberalization of services beyond what is already available as a result of unilateral actions by the member states or is included in multilateral accords such as the General Agreement on Trade in Services. There is good reason for including modern services in RTAs, since they play a larger role in the economies of developing countries and also bring in additional foreign investment flows to them. Including modern services is particularly important for an arrangement that would involve Kashmir, because tourism, as discussed later, has an enormous potential for providing employment to the state's young population and for accelerating its economic growth rate.

According to a recent study on economic integration in Latin America, controlling for other factors, countries with fully liberalized financial and telecommunications sectors grew annually about 1.5 percentage points higher on average than did countries with more closed economies.[55] There are good reasons for that, because preferential treatment of services in a region allows more suppliers to compete in the market and results in lower prices for consumers and greater efficiency. Besides, including services in an agreement does not result in revenue losses for the governments because, unlike goods, their movements across international borders are normally not taxed.

Do RTAs attract more investment? Would a subregional trade arrangement built around Kashmir bring in investment from the outside world? That these things should happen for domestic investment is obvious, but is there an impact on FDI? The World Bank recently investigated the effects of RTA membership and other variables on FDI flows for 152 countries over a period of twenty-two years, from 1980 to 2002. The study covered 238 RTAs. In general, it found that the countries that were open (measured as the ratio of trade to GDP) grew more rapidly, were more stable (measured in terms of the rates of inflation), and attracted greater amounts of FDI. On average, a 10 percent increase in market size associated with an RTA produces an increase of 5 percent in FDI. However, the study underscored that an RTA cannot substitute for an adequate investment climate.[56] In the case of Kashmir, economic growth will only happen once the insurgency that has gone on for a decade and a half has been subdued not by force, as was the Indian objective until 2003, but by providing the state's young an alternative way of life. Instead of pursuit of jihad, the youth have to be engaged in the state's economy.

Once peace is obtained, Kashmir should be an attractive destination for FDI. International hotel chains, operators of winter resorts, and organizers of hiking and other mountain sports will certainly be attracted to the state. Kashmir has much to offer as a holiday destination for the aging but rich population of the industrial world, as well as for the hardworking young Asians who, having become integrated into the global workforce, have money to spend on recreation.

The analysts who support RTAs as stepping-stones toward free international trade maintain that geographical proximity is a good reason to encourage them. In supporting the "natural bloc" concept, some trade experts have used "gravity models"[57] to argue that geography is a good determinant of the quantum of trade.[58] It is natural for neighboring countries to trade extensively among themselves. However, geographical proximity has not worked in South Asia, where intraregional trade remains an insignificant component of total trade. This situation—labeled "inverse regionalism"[59] by some analysts—is not just due to political problems between India and Pakistan. Geographical proximity, it is argued, is not good enough reason to deploy a great deal of political and bureaucratic energy in moving toward regional integration in South Asia. But this argument is incorrect. There is no reason why the South Asian countries should not be able to increase trade with one another once they have overcome some of their political inhibitions. Some past attempts were not successful because they were approached with a narrow view of regional integration—to preserve national interests and jealously guard all aspects of national sovereignty—rather than a broader view—to lay the groundwork for improving economic welfare of all citizens of the region. The approach presented in this study makes a South Asian RTA an integral part of resolving the Kashmir dispute, which has cast such a deep and dark shadow over relations between India and Pakistan. Also, as suggested by experience in other parts of the world, RTAs do not necessarily introduce great inefficiencies into the economies of member countries. In the case of South Asia—particularly in the case of India, Pakistan, and Kashmir—a cost–benefit analysis that also includes political gains would suggest that such an approach—that is, one that accelerates the pace of growth and resolves the outstanding political dispute—has great merit.

Attempts at Regional Integration in South Asia[60]

Over the past decade and a half, South Asian countries have made a series of attempts to improve regional trade. Formal agreements were less effective, however, than changes in macroeconomic policies, in particular the adoption by most countries of market exchange rates for promoting regional trade. The seven members of the SAARC—an organization set up in 1985 largely at the initiative of President Zia ur Rahman of Bangladesh—agreed to a charter aimed at

> (a) promot[ing] the welfare of the peoples of South Asia and to improve their quality of life; (b) accelerat[ing] economic growth, social progress and cultural development in the region and to provide all individuals the opportunity to live in dignity and to realize their full potentials; (c) promot[ing] and strengthen[ing] collective self reliance among the countries of South Asia; (d) contribut[ing] to mutual trust, understanding and appreciation of one another's problems; (e) promot[ing] active and mutual assistance in the economic, social, cultural, technical and scientific fields; (f) strengthen[ing] cooperation with other developing countries; (g) strengthen[ing] cooperation among themselves in international forums on matters of common interests; and (h) cooperat[ing] with international and regional organizations with similar aims and purposes.[61]

A secretariat was set up in 1986 in Katmandu, the capital of Nepal, headed by a secretary-general and one director from each of the member countries, to facilitate the work of the organization. Until the 1990s, the secretariat was not asked to work on issues related to economic cooperation and integration. However, in April 1993, the SAARC Council of Ministers signed an agreement to form the South Asian Preferential Trading Arrangement (SAPTA). The agreement became operational in December 1995. Following SAPTA's establishment, three rounds of preferential tariff reductions were implemented. The coverage of SAPTA-1, concluded in 1995, was very modest. It covered only 6 percent of traded goods (about 226 products at six-digit HS [Harmonized Systems] level). The important issue of nontariff barriers to trade was not included; they were left to be dealt with at a later date. SAPTA-2, concluded in 1997, was slightly more ambitious; it covered 1,800 six-digit HS items and also incorporated provisions about easing some of the nontariff barriers to trade. SAPTA-3, signed in 1998, was the most ambitious of the three agreements. It covered 2,700 items. Work on SAPTA-4 was initiated in 1999 but was put on hold after the military takeover in Pakistan on October 12, 1999, and an enormous increase in tension between India and Pakistan in 2001–02. Politics had once again intervened in the halting advance of regional integration in South Asia.

As experience in other parts of the world indicates, regional trading arrangements succeed only when they are backed by strong political will and strong political support within member countries. These have been absent up until now in South Asia, largely on account of the decades of ill feeling built up between India and Pakistan. The recent easing of tension between the two countries and the serious public commitment made by the Indian prime minister and the Pakistani president—most recently on April 19, 2005, at the New Delhi summit—indicates that there is now considerable political will for greater regional integration. Public support for better relations between the two countries is also in evidence.

Table 15. Summary of Tariff Structures in South Asia

	India March 04	Pakistan 2002/03	Bangladesh[a] 2004/05	Sri Lanka Feb 04	Nepal Aug 03
Top normal CD rate	30[b]	25	25.0	27.5	25
Other normal protective taxes	0	—	4.0	3.75	4.5
Top normal protection rate	30	25	29.0	31.25	29.5
Average CD rate	22.2	17.3	16.3	11.3	13.7
Average of other normal protective taxes	0	1.5	3.9	2.1	4.3
Average of other protective taxes	0	0	6.3	0	
Average CD+other protective taxes	22.2	18.8	26.5	13.4	18.0
% of products with total protection rates>normal maximum protection rate[c]	2.8	1.1	15.8	0.9	5.8
Number of normal CD slabs	7	4	4	6	5
Number of CD slabs>normal	17	10	None: uses para-tariffs & VAT exemption for extra protection	2	3
Range of CD slabs>normal	40–210%	40–250%		75 & 100%	40, 80, 130%
% of ad valorem tariff lines>normal CD rate	2	0.1		0.2	5.2
% of tariff lines with specific duties	5.3	0.9		1.2	0.6

Notes:
CD = customs duty; VAT = value-added tax.

[a] Tariff data on Bangladesh as of June 2004. These figures reflect tariff changes announced in the FY05 budget on June 10, 2004, which indicated a significant move toward reduction of protection via reduction of the top rate to 25, a move to three nonzero tariff slabs, and rationalization of supplementary duties.

[b] The "general maximum" CD rate is defined as a rate that includes at least 5 percent of total tariff lines and above which there are no more than 10 percent of total tariff lines. The "general maximum" is 30 percent in India because of the large number of agricultural customs duties clustered at this rate. The Indian general maximum CD rate for industrial tariffs is 20 percent.

[c] Percentage of tariff lines with total protection rates (inclusive of selective para-tariffs) in excess of "normal maximum" CD plus normal (generally used) para-tariffs.

Source: *Trade Policies in South Asia: An Overview.*

The Islamabad Summit Declaration, 2004[62]

At their summit held in Islamabad, the seven heads of state of the SAARC nations took a major step toward regional economic integration and agreed to launch SAFTA by January 2006. This step should have been taken earlier. At their summit in 1997, the SAARC leaders had agreed to launch SAFTA by 2001. The five-year delay was caused by the rapid deterioration of relations between India and Pakistan following the nuclear tests by the two countries in May 1998, the military takeover in Pakistan in October 1999, and the near-war between the two countries in 2001–02, when more than a million soldiers were amassed along the long Indo-Pakistan border. There was a sudden easing of tension between the two nations starting in April 2003 when Atal Bihari Vajpayee, then prime minister of India, "held out a hand of peace to Pakistan" and pledged to work toward creating a peaceful South Asian region.

SAFTA is a traditional trade agreement in the sense that it does not include some of the non-trade issues that have been incorporated into some new RTAs in other parts of the world. In that sense, South Asia is still playing catch-up with other developing regions. SAFTA covers tariff reductions, rules of origin, safeguards, institutional structures, and dispute settlement. It also calls for the adoption of various trade facilitation measures, such as harmonization of standards and mutual recognition of test results, harmonization of customs procedures, and cooperation in improving transport infrastructure.

The SAFTA tariff reduction program stipulates tariffs of 20 percent by the region's more developed economies—India, Pakistan, and Sri Lanka—within two years of the entry into force of the agreement. The region's least developed countries—Bangladesh, Bhutan, Maldives, and Nepal—were granted a longer period to make the adjustment to a lower level. These countries are required to establish tariffs of 30 percent in the same period but are allowed longer periods for the second downward adjustment, when tariffs would be reduced to the 0 to 5 percent range. India and Pakistan will adjust to these lower levels in five years after the completion of the first phase, Sri Lanka in six years, and Bangladesh, Bhutan, Maldives, and Nepal in eight years. India, Pakistan, and Sri Lanka will reduce their tariffs to the low levels on imports from other countries no later than January 1, 2009. The agreement also calls for elimination of all quantitative restrictions for products on the tariff liberalization list. While the member states have been allowed to develop lists of sensitive items that would not be subjected to the full stipulated tariff cuts, the number of products to be included in the country lists would be subject to review every four years.

The Islamabad declaration established institutional mechanisms to oversee the implementation of the SAFTA agreement. A Ministerial Council was appointed as the highest decision-making authority, while a Committee of Experts (COE) was formed to monitor in detail implementation of the agreement and to resolve disputes. The COE is required to report to the ministers every six months on the progress of the agreement, which is to be fully implemented by 2015.[63]

The Ministerial Council has held several meetings since the signing of the SAFTA declaration and made considerable progress on two of the four issues assigned to it. It has agreed to sensitive lists prepared by individual countries and has also agreed on a formula pertaining to the rules of origin. Initially, not much progress was made on the issues of compensation and technical assistance to the least developed countries (LDCs) in the region. India, Pakistan, and Sri Lanka—the non-LDCs—argued that compensation was never included in any other RTA and that its incorporation in the SAFTA would signal that the agreement would divert rather than create trade among member countries. The non-LDCs also indicated that they did not have the economic capacity to provide a substantial amount of technical assistance to the LDCs. These and other matters were to be discussed at the SAARC summit scheduled to be held in Dhaka on January 9–11, 2005. The meeting was twice postponed, once because of the havoc caused by the tsunami on December 26, 2004, and the second time because of the move by the king of Nepal against the elected government of his country. The Nepalese action was not well received by New Delhi; the Indian prime minister's office announced that it would not be prudent for that country's leader to sit at the same table with a political usurper. India, in other words, was proclaiming by this action that to remain in SAARC and SAFTA, a country had to have a democratic form of governance. By taking action against Nepal, India was also indirectly sending a strong signal to Islamabad and its military-dominated regime. Once again—although this time a different set of countries were involved—politics intervened to stop progress toward regional economic integration.

The inauguration of SAFTA was delayed by six months to provide more time for the COE to conclude its work and to have all countries formally ratify the Islamabad declaration. In March 2006, Pakistan became the last country to do so. The first round of tariff reductions finally began on July 1, 2006. If SAFTA achieves its potential, it will change the structure of regional trade within South Asia (see tables 16 and 17).

Table 16. Source of Imports into the SAFTA Countries (percent of total)

Source	Bangladesh	Bhutan	India	Maldives	Nepal	Pakistan	Sri Lanka
United States	4	2	7	1	3	9	4
United Kingdom	2	3	5	2	1	5	4
Germany	2	4	4	1	4	7	2
China	17	1	5	1	14	16	4
Singapore	12	2	2	26	9	5	7
Japan	7	16	3	2	2	9	6
Republic of Korea	8	2	2	—	2	5	5
India	19	62	—	11	47	>1	14

Notes: SAFTA = South Asia Free Trade Association

Source: U.S. International Trade Commission, COMTRADE Statistics 2004.

Table 17. Intraregional Trade (US$m)

Destination	Bangladesh[a]	Bhutan	India	Maldives	Nepal[a]	Pakistan[a]	Sri Lanka
Sri Lanka	4	0	917	14	0.188	NR	
Pakistan	NR	NR	205	0	NR		29
Nepal	NR	NR	349	0		NR	1
Maldives	0	0	31		0.016	2	45
India	62	32		0.118	280	45	169
Bhutan	NR		39	0	NR	NR	0
Bangladesh		NR	1,170	0	NR	NR	9

Notes: NR = neither country reports

[a] Nonreporting country

Source: U.S. International Trade Commission, COMTRADE Statistics 2004.

5 FOSTERING PEACE IN KASHMIR WITHIN THE SAFTA FRAMEWORK

The effort to build a free-trade area in South Asia over the period of a decade offers a unique opportunity for laying the groundwork to resolve the Kashmir problem. Indeed, this groundwork could be laid within the SAFTA framework already agreed on by the SAARC countries. In particular, an economic development program for Kashmir could be formulated that would rely heavily on greater trade among India and Pakistan and the state of Kashmir.

Exactly how would a subregional trading arrangement work for Kashmir in the context of SAFTA? As already suggested, a subregional agreement involving India, Pakistan, and the two parts of Kashmir has a realistic chance of success within the SAFTA framework in part because it provides for the multilateral supervision that India has thus far been unprepared to accept as a part of the Kashmir problem. The SAARC could admit Kashmir into its ambit as a quasi-state, leaving its exact political status undetermined. The present Line of Control (LOC) could become a soft border between Kashmir's two parts. This quasi-state could be given the same rights as the LDCs (Bangladesh, Bhutan, Maldives, and Nepal) in the original framework. The quasi-state would have no border controls along the LOC, meaning customs and immigration procedures would be established on the borders with India and Pakistan. However, goods and commodities would be allowed free entry from Kashmir to both India and Pakistan. Duties would be levied only on imports into the region, with revenues split between the two administrations—one in Srinagar and the other in Muzaffarabad—on the basis of population.

Additionally, Kashmiri citizens, carrying a separate identity card, would have total freedom of access to India and Pakistan. Only when leaving the two countries would they be required to carry national passports. Citizenship will continue to be determined on the basis of residence in Kashmir. This twin documentation approach—an identity card and a national passport—is one solution to the problem India and Pakistan have faced in allowing travel across the LOC. Once Kashmir has been incorporated as a substate (or a quasi-state) in SAFTA, India and Pakistan should then formulate a ten-year economic development plan focused on a few high-priority sectors.

Because such a plan would cost tens of billions of dollars to implement, it would require the active support of the international community. However, a development plan focused on the state's physical and human endowment will work only if it gains political acceptance from the parties involved in the dispute. For that to happen, the plan must not change the political status of the state for some time to come; otherwise, it would not be acceptable to India. It also must not suggest that the present LOC will become the international boundary. That would not be acceptable to Islamabad. Even with these two constraints, there is enough space left within which a plan could be formulated. That noted, the plan would have to be ambitious and broad enough to increase the economic welfare for the citizens of Kashmir, to initiate a process that could ultimately lead to the resolution of the dispute, and to draw foreign support for its implementation.

For this to occur, the plan must fully involve the people of Kashmir, the governments and people of India and Pakistan, and the international community. The main focus of the plan would be to develop exchanges—that is, the movement of people, goods, and services—among Kashmir, India, and Pakistan. The aim would be to develop an integrated market in the region, which could develop into a common market. Such a market could later encompass other parts of South Asia. In fact, a plan of economic and trade integration involving Kashmir and the contiguous parts of India and Pakistan could become a stepping-stone toward the establishment of the free-trade area in South Asia envisioned in the Islamabad declaration of January 6, 2004.

The plan could be built around five central elements: developing the state's water resources with a view toward generating electric power; rebuilding and expanding the tourism industry; developing forestry and high-value-added agriculture; improving physical infrastructure; and developing human resources to engage the young in the more productive sectors of what would essentially be a new economy.

Hydroelectricity

The first element would involve reinterpreting rather than renegotiating the Indus Water Treaty of 1960, which distributed the waters of the Indus River system between India and Pakistan. The main aim of the treaty was to make enough water available in the eastern rivers so that the irrigation system that relied on these rivers and served many parts of Pakistan would not go dry. The treaty was remarkably successful in that it prevented a major confrontation between India and Pakistan on the issue of the use of water from the Indus system. Kashmir's accession to India had placed India at the top of the British-built system of irrigation. India had plans to use its upper riparian status to irrigate the deserts of Rajasthan with water drawn from the Indus tributaries. Soon after gaining independence, it began work on the Bhakara dam project to bring new land under cultivation in Rajasthan. This would have resulted in a serious reduction in the amount of water flowing into Pakistan. With the treaty in place, India could achieve that objective without reducing the availability of water flowing through Pakistan's rivers and canals.

From Kashmir's perspective, the treaty froze the development of water and hydroelectric power resources for its own people. The question is whether the treaty could be reinterpreted not to reduce the flow of water to Pakistan but to jointly develop hydroelectricity to benefit Pakistan, the northern states of India, and Kashmir. This could be done on the basis of a careful study of the power potential of the Indus system for the purpose of developing it so that it brings benefit to the power-short regions of Kashmir, Pakistan, and the northern parts of India. An important component of this plan would be to build an integrated power grid to serve the three areas. This plan could aim to generate between 5,000 and 7,500 megawatts of additional power for use in the three areas. The total cost to be incurred over a ten-year period would be about $10 billion.[64]

Both India and Pakistan are working separately to develop the hydroelectricity potential of the rivers flowing through their parts of Kashmir. The Indian efforts have created considerable apprehension in Pakistan and a belief that the authorities in New Delhi are attempting to subvert the Indian treaty. In particular, Islamabad has serious concerns about the Wullar Lake, Baglihar Dam, and Kishenganga Dam projects, which it sees as attempts to draw more water from the tributaries of the Indus River than India is allowed under the 1960 treaty. As a result, Pakistan has invoked a provision in the 1960 treaty that allows for external arbitration in case a dispute concerning water distribution in the system cannot be resolved by the two governments on their own. It has also speeded up its plan to construct a dam on the Neelum River downstream of the Kishenganga site.

There is, therefore, an opportunity to summon experts from both sides to develop a plan that would tap the power potential of the rivers in Kashmir without disturbing the water distribution agreement of the Indus Water Treaty. This is best done within the scope of a subregional treaty, since the amount of power that could ultimately be generated is far in excess of the future demand of the state of Kashmir. There will be a need—and an opportunity—to sell the surplus power through a regional grid to India and Pakistan.

Tourism

Tourism could also prove to be the source of a significant amount of capital flow into the state and of employment for the area's workforce. The insurgency that has lasted for a decade and a half has both undermined the infrastructure that supported tourism and turned people away from the state on account of lack of security.

Kashmir became a major destination for Indian tourism in the 1980s; by 1981 the number of visitors from India had reached 600,000 (see table 18). The state also attracted some foreigners, but not as many as it could have given its beauty. The proportion of foreign tourists remained about one-tenth of the total. The year before the beginning of the current insurrection, tourists visiting the state numbered almost three-quarters of a million. That was the peak year for tourism in the state. Thereafter, the number of visitors declined rapidly, contributing to Kashmir's economic problems. The plan proposed here aims to turn Kashmir, along with Pakistan's northern areas, into an international and regional tourism destination.

Tourism is the fastest growing part of the service sector in the global economy; new consumers are entering the sector as populations age and personal incomes increase. There are reports that some 100 million Chinese may be prepared to join the tourist trade as consumers. Pakistan's northern areas and Kashmir would offer attractive places for the Chinese to visit, as much of that country's ancient history has roots in these areas. The same applies to tourists from Japan and other East Asian countries. Before these areas can become an attractive

Table 18. Tourists Visiting Kashmir

	Indians	Foreigners	Total	% of Foreigners
	(in 000s)			
1951	9	1	10	10.0
1961	63	11	74	14.9
1971	176	20	196	10.2
1981	599	44	643	6.8
1988	662	60	722	9.6
1991	1	4	5	80.0
2001	67	6	73	8.3

Source: Jasbir Singh, *The Economy of Jammu & Kashmir* (Jammu: Radha Krishan Anand, 2004), table 6.1, pp. 235–236.

tourist destination, however, considerable investment will be needed first both to develop the infrastructure and to train the people to manage the industry. The needed infrastructure includes roads that can take heavy traffic, airports, hotels, and restaurants. New museums would also need to be built, and the sites that have specific appeal to East Asian tourists—Kashmir was once the center of Buddhism—will need to be developed. An investment of some $5 billion would be required—most of it from the private sector—to get tourists in large numbers to come to the area. Benefits would flow to Kashmir and the northern parts of India and Pakistan.

Forestry and Orchards

Kashmir's third major economic asset is its forestry and orchards. The products offered by this sector are in considerable demand not only in the West but also in China. Kashmir also has the raw material and skills needed to develop a high-value-added furniture industry. With security returning to the area, it should be possible to engage major transnational corporations that specialize in manufacturing and distributing furniture in developing this part of Kashmir's economy. Much of the investment required in this sector could come from these corporations; they would also be able to provide management expertise and design capacity for a successful export-oriented furniture industry. Resource commitment by the public sector would not need to be large, although the state would have to establish training institutions to develop the required skills. India could help in this respect, using its well-developed institutional infrastructure to provide technical assistance.

The state's well-earned reputation as an "orchard of the East," meanwhile, is based on a combination of good soils, appropriate altitude, and proper climate that makes the land suitable for cultivating a wide variety of fruits that have markets in the West and the Middle East.

To achieve full potential in this area, the government, with help from transnational corporations, will need to develop an integrated development program with detailed costs and cost sharing. The total amount of expenditure envisaged for this sector is about $4 billion.

Physical Infrastructure

Before India and Pakistan gained independence, Kashmir's physical infrastructure—mostly roads—catered to tourism. The state was not part of the area the British had regarded as either strategically sensitive (as was the case with Punjab, the Northwestern Frontier Province, and, to a lesser extent, Balochistan) or economically important (as was the case with Punjab and Sindh provinces). As a result, strategic and economic considerations resulted in massive investments by the British to develop roads, railways, and irrigation systems in Punjab and Sindh. No such incentives were present in the princely state of Kashmir. The small amounts of investments made were aimed to facilitate the movement of tourists, most of them British, into the area. The tourist infrastructure existed around Srinagar, the state capital, and the main link to it was from Rawalpindi, a British garrison town in the northwestern part of Punjab province.

The road from Rawalpindi climbed steeply toward Murree, hugging the foothills of the Himalayas. After reaching a height of 7,000 feet, it wound down toward Muzaffarabad, a small city in the western part of Kashmir situated on the confluence of two mighty rivers, the Neelum and the Jhelum. (Muzaffarabad was almost totally destroyed by the earthquake of October 8, 2005.) From Muzaffarabad the road crossed the Jhelum and went on first to Baramula and then to Srinagar. There were also road links, albeit less traveled ones, between Jammu and Sialkot in Pakistan. The only railway link was between Sialkot and Jammu. On the Indian side, the railway system terminated at Pathankot, short of the boundary with Kashmir. Thus, Kashmir's natural communication links were with Pakistan.

A program for infrastructural development in the state would have two components: the development of communications within the state to serve the major centers of economic activity centered around high-value agriculture, forestry, and tourism and better connections with the world outside. Most of this development will have to be through Pakistan, exploiting the road and railway networks that already exist in that country. Pakistan's well-developed Karakorum Highway that links Islamabad with Kashgar in western China provides easy access to Kashmir via the roads to Rawalpindi and along the Neelum River to Abbolabad. The railway link between Sialkot and Jammu, which is now in a stage of advanced disrepair, could be put back to use, linking the state with the railway systems of India and Pakistan through the city of Lahore.

Pakistan's recent investment in a modern airport in Lahore could bring in feeder services from Srinagar, Jammu, and other cities in the state to points in India and the world outside. Lahore already has a well-developed facility for handling air cargo for export of the items that would be of interest to a revived Kashmiri economy. Woolen shawls, animal skins, and wooden artifacts are delicate products that need to be air freighted. This could be done through Lahore.

The program of infrastructure development proposed in this study is less ambitious than that for the development of energy resources and will cost roughly $3 billion over a ten-year period. This does not, however, include the massive investment that will be needed to restore the infrastructure destroyed by the earthquake.

Human Resources

Another important component of the plan would be to improve the quality of human resources in Kashmir by providing education and skills to the young to help them participate in the modern economy. The quality of human resources there has suffered a significant decline since the beginning of the insurgency. One way of assessing the impact is to use the human development index developed by the United Nations Development Programme for its *Human Development Reports*. According to the Indian Planning Commission, the ranking of the state of Kashmir declined from nineteenth among thirty-two political jurisdictions in 1981 to twenty-first in 1991. The Commission's *Human Development Report, 2001,* did not estimate the value for Kashmir. In 1981, the Human Development Index (HDI) for the state was calculated at 0.337 compared with the Indian average of 0.302. Chandigarh, with a value of 0.550, had the highest ranking, whereas Bihar had the lowest ranking at 0.237. In 1991, Kashmir's HDI was estimated at 0.402, with Chandigarh still in first place at 0.674 and Bihar still in last place at 0.308. The overall value for India was 0.381.[65]

Kashmir did particularly poorly in terms of literacy. This is especially unfortunate as the state had one of the highest rates of literacy among the various political jurisdictions of British India. In 2001, for example, the literacy rate was only 54.5 percent for the entire population: 60.1 percent for males and 41.8 percent for females. On this score, the state ranked thirty-third among thirty-five jurisdictions of India. The Indian average for that year was 65.4 percent: 75.9 percent for males and 54.2 percent for females.[66]

Before the start of the insurgency, Kashmir's economy had a very small modern component. The development of the modern sector suffered because the uncertainty created by the insurgency discouraged new investment. But the revival of the state's economy, if undertaken according to the plan proposed here, would create entrepreneurial and employment opportunities in several sectors. To prepare the population to participate in these sectors would require large amounts of additional investment in education. It would also need the establishment of specialized institutions linked with those already working in India and Pakistan as well as in more advanced countries. The total cost of this effort is estimated at $2 billion over ten years.

Kashmir and a Subregional Trading Arrangement

The $20 billion program of development proposed here would add significantly to the state's growth rate if it were accompanied by a trading arrangement that allows access to Pakistan.

This could be achieved within a subregional trade agreement involving India, Pakistan, and Kashmir. Such an arrangement could be a corollary to SAFTA.

An India–Pakistan–Kashmir regional trade pact could go beyond that envisaged within the context of SAFTA. It could focus not just on allowing tariff-free access among the participants for the goods they produce. It could also include the sectors excluded for the time being from SAFTA. Of particular relevance for such an arrangement would be services and movement of people. As discussed above, tourism is of special significance for the state. Including it within a subregional trade arrangement would allow free access to potential tourists from Pakistan to Kashmir and India, and from India and Kashmir to Pakistan. The Chinese should also be able to use the established land links between their country and Pakistan to gain access to the attractions Kashmir has to offer.

The free movement of people between Kashmir and Pakistan would reverse the constraints on travel that resulted from the long-enduring conflict involving the state. Such movement could integrate the sizeable handicraft industry that exists on both sides of the current divide in Kashmir. Before the partition of British India and the conflict over Kashmir, the Kashmiri handicraft industry, including wool weaving and woodworking, had strong links with the handicraft industry in the border cities of Rawalpindi and Sialkot. Those links could be reestablished.

Would such an arrangement be practical? Would India and Pakistan be prepared to work on it as a way of finding a lasting solution to the conflict? At this time, India seems inclined to move toward such an option. In late November 2004, in a wide-ranging discussion with the press following the visit to Delhi by Shaukat Aziz, Pakistani prime minister Natwar Singh said that "the two countries could settle the Kashmir dispute only if they strengthened ties, increased trade and brought people on the two sides closer to prepare them to accept a compromise." Indeed, a subregional trade arrangement involving India, Pakistan, and Kashmir could be concluded only if Delhi was prepared to grant the state economic and political powers that go beyond those given to the other states. This would imply much greater autonomy than that given to Kashmir in Article 370 of the Indian Constitution, but India seems willing to offer that. Pakistan seems to be moving in the same direction. "We have made it clear . . . as far as regional autonomy is concerned, [the] sky is the limit," Singh told the news conference.[67] "General Musharraf talks of offering the people of Kashmir . . . 'something between autonomy and independence, like self-governance.' This could be 'over-watched' by all three parties."[68]

What would be the impact of this $20 billion development plan on Kashmir (see table 19)—on the state's rate of economic growth, on employment, on the incidence of poverty, and on bringing about a greater integration of the state with the global economy? Using a simple model, this level of investment spread over a ten-year period on both sides of the present divide should yield $40 million of additional income a year. This would correspond to an increase of 9.5 percent a year in the GSDP of both parts of Kashmir. The combined gross product of the two sides is approximately $4.2 billion—$3.3 billion for the part held by India and $900 million for the parts held by Pakistan—so this target is not impossible to achieve considering that the economy of both parts of Kashmir has grown at a rate well below the Indian and Pakistani average, respectively.

Table 19. The Plan for Kashmir's Economic Development (2005–2015)

	Amounts in $ billion	% of the total
Hydroelectricity	7.0	35
Tourism	3.0	15
High value agriculture	4.0	20
Infrastructure	3.0	15
Human development	2.0	10
Total	**20.0**	**100**

The total population of Kashmir in 2004 was 14 million, 11 million on the Indian side of the border and 3 million on the Pakistani side. The population is likely to reach 17.5 million by 2015. A 9.5 percent growth in GSDP would mean that the size of the economy would increase in constant terms to $10.4 billion, which would, in turn, increase per capita income to $745 and bring it close to the anticipated incomes in both India and Pakistan.

6 CONCLUSION

In early 2004, India and Pakistan decided to start what they called a "composite dialogue" to resolve their outstanding disputes. By far the most important problem of the eight that were identified in the Islamabad summit was the issue of Kashmir. However, their respective positions have hardened over time, and no breakthrough can be expected in this area. Given that, I have developed two themes in this study. The first is that it is useful to demonstrate the enormous economic, social, and political costs that have been incurred by the two sides—in particular, by Pakistan—as a result of the continuing problem of Kashmir. Specifically, I have developed an analytical framework for estimating the opportunity cost of the Kashmir problem for Pakistan. Had Kashmir not become such a divisive issue, Pakistan's economy would have fared considerably better than it has. The recognition of this fact should develop a constituency for peace, particularly in Pakistan.

The second line of argument advanced in this study is that the constituency for peace could be enlarged and strengthened if the two countries were to set up a regional trade arrangement involving them and the two parts of Kashmir. Within such an arrangement, a large development program could be implemented that would bring handsome economic rewards to the citizens of the state. Such a program should be able to attract resources from the donor community, particularly given the importance of Kashmir for bringing political, social, and economic security to all of South Asia. I estimate the cost of this program at $20 billion over a ten-year period and suggest that that would bring the rate of GDP growth in the two parts of Kashmir to about the average for South Asia. This in itself should increase the desire for a peaceful solution to the problem of Kashmir.

NOTES

1. The Kashmir dispute has attracted a great deal of academic interest not only among scholars in India, Pakistan, and Kashmir but also among foreigners. Among the more notable works, listed in alphabetical order by the name of authors, are M .J. Akbar, *Kashmir Behind the Vale* (New Delhi: Penguin, 1991); Ajit Bhattacharya, *Kashmir: The Wounded Valley* (Delhi: UBSPD, 1994); Sumantra Bose, *Kashmir: Roots of Conflict, Paths to Peace* (Cambridge, MA: Harvard University Press, 2003); Sisir Gupta, *Kashmir: A Study in India-Pakistan Relations* (Bombay: Asias Publishing House, 1966); Joseph Korbel, *Danger in Kashmir* (Princeton, NJ: Princeton University Press, 1954); Alistair Lamb, *Kashmir: A Disputed Legacy* (Karachi, Pakistan: Oxford University Press, 1993); Balraj Puri, *Kashmir: Towards Insurgency* (Delhi: Orient Longman, 1993); Mushtaq ur Rahman, *Divided Kashmir: Old Problems, New Opportunities for India, Pakistan and the Kashmiri People* (London: Lynne Rienner Publishers, 1996); Victoria Schofield, *Kashmir in the Crossfire* (London: I.B. Tauris, 1996); Tavleen Singh, *Kashmir: A Tragedy of Errors* (Delhi: Penguin, 1995); Robert G. Wirsing, *India, Pakistan, and the Kashmir Dispute* (London: Palgrave Macmillan, 1997); Robert G. Wirsing, *Kashmir in the Shadow of War: Regional Rivalries in a Nuclear Age* (New York: M.E. Sharp, 2002).

2. This is a very controversial subject and views vary wildly. For a selection of different approaches to this subject, see Alex Ninian, "Hindu and Muslim Strife in India," *Contemporary Review* 280, no. 1637 (June 2002), 340–343; Yoginder Sikand, "Another Ayodhya in the Making: The Baba Budhangiri Dargah Controversy in South India," *Journal of Muslim Minority Affairs* 20, no. 2 (2000), 211–227; Radha Kumar, "India's House Divided: Understanding Communal Violence," *Foreign Affairs* 81, no. 4 (July/Aug. 2002): 171–177; Paul R. Brass, *The Production of Hindu-Muslim Violence in Contemporary India* (Jackson School Publications in International Studies) (Seattle: University of Washington Press, 2005); Steven I. Wilkinson, *Religious Politics and Communal Violence,* Critical Issues in Indian Politics (New York: Oxford University Press, 2005); Ashutosh Varshney, *Ethnic Conflict and Civic Life: Hindus and Muslims in India* (New Haven, CT: Yale University Press, 2003).

3. The scope of SAFTA changed even before it was formally launched: Afghanistan was invited to join the South Asian Association for Regional Cooperation, SAARC, at the thirteenth meeting of the organization's summit held in Dhaka in November 2005. It will become the eighth member of SAFTA.

4. Alexander Evans, "The Kashmir Insurgency: As Bad As It Gets," *Small Wars and Insurgencies* 11, no. 1 (Spring 2000), 69–81; Sumantra Bose, "Kashmir: Sources of Conflict, Dimensions of Peace," *Survival* 41, no. 3 (Autumn 1999), 87–98; Victoria Schofield, *Kashmir in Conflict: India, Pakistan and the Unfinished War* (New York: I.B. Tauris, 2000); Amir Mohammad Rana, *Jihad-e-Kashmir Aur Afghanistan (The Jihad in Kashmir and Afghanistan)* (Lahore, Pakistan: Mashaal Books, 2002). In Urdu: The claims of state excesses perpetrated by New Delhi are numerous and well founded. See, for example, "India: Impunity Must End in Jammu and Kashmir," April 21, 2001, Amnesty International. Available at http://web.amnesty.org/library/Index/ENGASA200232001?open&of=ENG- (accessed October 21, 2003). Also see "India: A Trail of Unlawful Killings in Kashmir: Chithisinghpora and Its

Aftermath," June 15, 2000. Available at http://web.amnesty.org/library/Index/ENGASA2002 42000?open&of=ENG-IND (accessed October 21, 2003). However, Pakistan's own support of militants attacking civilians comes under fire by the same organization. See, for example, "India: Attacks Unacceptable," August 26, 2003. Available at http://web.amnesty.org/ENGA SA200222003?open&of=ENG-IND (accessed October 21, 2003).

5. Per capita growth rates are more indicative of development than aggregate growth rates, while gross and net estimates are equally useful for a state such as Kashmir. Gross domestic product (GDP) is estimated by factoring in incomes from outside the border, which are of considerable importance for the state as a large number of people live outside its borders and remitting incomes to families, friends, and dependents. The tables use estimates from two different series of state domestic incomes; the first uses 1980–81 prices as the base, and the second uses 1993–94 prices. According to the 1980–81 base series, per capita incomes in Kashmir increased by less than 1 percent in the thirteen-year period between 1980–81 and 1993–94. This increase was only 25 percent of the Indian national average. The increase in per capita income according to the second series was slightly more than 50 percent of the national average. In terms of net product, Kashmir's per capita income increase was less than 50 percent of the national average according to the first series and less than 75 percent according to the second series.

6. I am working on an economic history of Pakistan for 1947–2007.

7. There is a growing literature on the subject of Asians in the United Kingdom, including those from the Pakistani part of Kashmir. See, for instance, Alison Shaw, *Kinship and Continuity: Pakistani Families in Britain* (London: Routledge, 2000); Robin Cohen, *The Cambridge Survey of World Migration* (Cambridge, UK: Cambridge University Press, 1995); and Rozina Visram, *Asians in Britain: 400 Years of History* (London: Pluto Press, 2002).

8. Government of Pakistan, *Medium-term Economic Framework, 2005–2015* (Islamabad: Planning Commission, 2004) provides estimates for incremental capital output ratio (ICOR) in Pakistan and how they are expected to change over time.

9. This fact has been recognized by a number of Indian sources. See, in particular, Jasbir Singh, *The Economy of Jammu and Kashmir* (Jammu, Radha Krishna Anand and Co., 2004), the most detailed published account to date on the development of the economy of the part of the state controlled by India.

10. This incident is well covered by Own Bennet Jones in *Pakistan: Eye of the Storm* (London, Yale University Press, 2002, 34–56).

11. See Stanley Wolpert, *Nehru: A Tryst With Destiny* (New York: Oxford University Press, 1997).

12. The role of agriculture in the development of Kashmir's economy is well covered in Jasbir Singh, *The Economy of Jammu and Kashmir* (Jammu: Radha Krishna Anand, 2004), 73–119.

13. M. Govinda Rao, "State Finances in India: Issues and Challenges," *Economic and Political Weekly* 37, no. 31 (August 3, 2002), 375–390.

14. The term Hindutva means 'Hinduness' and refers to a political movement that would like to see India become a Hindu state with Hinduism adopted as the state's official religion.

15. This point of view is strongly presented by Sumit Ganguly, an American scholar of Indian descent, in his contribution to a *Foreign Affairs* special section on the rise of India. See Sumit Ganguly, "The Kashmir Conundrum," *Foreign Affairs* (July/August 2006, 45–56.

16. Ganguly, "The Kashmir Conundrum," 51.

17. Incremental capital output ratio or ICOR is a measure of the proportion of GDP that needs to be invested in the economy to produce a 1 percent increase in gross domestic output. The lower the ICOR, the more efficient the economy.

18. The World Bank, *World Development Indicators, 2005* (Washington, DC, 2005), table 5.8, 298–301.

19. In estimating the impact on growth rate of GDP, I have used the incremental capital output approach. Pakistan's historical ICOR was used to estimate the likely increase in GDP growth if investments could be increased as a result, say, of reduced expenditure on defense.

20. For the way the first generation of Pakistani leaders viewed the attitude of their Indian counterparts toward their country, which was struggling to find its feet, see Chaudhri Muhammad Ali, *The Emergence of Pakistan* (New York: Columbia University Press, 1967). Ali, a senior Muslim bureaucrat, was a prominent participant in the negotiations that led to the creation of Pakistan in 1947 and went on to become Pakistan's prime minister in 1956. His account of the several attempts made by the administration headed by Jawaharlal Nehru, India's first prime minister, is also reflected in Stanley Wolpert, *Gandhi's Passion, The Life and Legacy of Mahatma Gandhi* (New York: Oxford University Press, 2001).

21. See Niall Ferguson, *Empire: How Britain Made the Modern World* (London: Allen Lane, 2003), 50–56; Eric Stokes, "Agrarian Relations: Northern and Central India" and Elizabeth Whiteombe, "Irrigation," in *The Cambridge Economic History of India, Vol. 2, c1757–c1970,* ed. Dharma Kumar and Meghdad Desai (Delhi: Orient Longmans, 1982), 36–86, 677–736.

22. See the studies by Stokes and Kumar and Desai cited in note 21.

23. William R. Cline, *Trade Policy and Global Poverty* (Washington, DC: Center for Global Development and Institute for International Economics, 2004), 280.

24. See United Nations Conference on Trade and Development (UNCTAD), *World Investment Report* (Geneva, 2005) for a detailed analysis of the performance of various world regions with respect to flows of FDI. South Asia is still doing much more poorly than East Asia.

25. UNCTAD, *World Investment Report*.

26. Government of Pakistan, *Pakistan Economic Survey, 2004–2005* (Islamabad: Ministry of Finance); tables in the statistical annex have data on national income accounts in both current and constant terms.

27. Khozem Merchant, "'Tata effect' looks set to weave its economic magic on Bangladesh," *Financial Times* (November 2, 2005), 3.

28. Based on Ijaz Nabi's comments on an earlier draft of this study. Nabi is an economist in the South Asia region of the World Bank.

29. See Bob Woodward's account of the exchanges between U.S. State Department's senior leaders (Secretary Colin Powell and Deputy Secretary Richard Armitage) and Pakistan's President Pervez Musharraf and Lt. General Mahmood Ahmad, director general of Interservices Intelligence (ISI), which resulted in a total change in Pakistan's Afghanistan strategy. Bob Woodward, *Bush at War* (New York: Simon and Schuster, 2002), 58–59.

30. Author's conversation with President Pervez Musharraf, March 2005.

31. The World Bank, *World Development Indicators, 2004*, tables 1 and 2.

32. See, for instance, UNCTAD, *Trade and Development Report, 2002* (Geneva, 2002).

33. UNCTAD, whose annual Trade and Development Report examines investment flows across borders, has identified factor endowments, presence of appropriate human capital, reasonable physical infrastructure, and investment environment as the main contributing factors to decisions concerning investments by transnational corporations. For the moment, TNC interest is confined to the western parts of India. My argument is that with a regional trade arrangement in place, South Asia could begin to attract TNC investments.

34. The World Bank, *World Development Indicators, 2005* (Washington, DC, 2005).

35. See UNCTAD, *Trade and Development Report, 2002* (Geneva, 2002).

36. Robin Cook, "A Strong Europe—or Bush's feral US capitalism," *The Guardian* (October 29, 2004), 26.

37. To date, the only extensive survey of the impact of SAFTA on South Asia and various countries in the region was conducted by a team of economists that I headed. The project was financed by the U.S. Agency for International Development (USAID). The impact of SAFTA on the economies of India and Pakistan is analyzed in two chapters Amita Batra, "Country Perspectives: India," and Shahid Javed Burki and Mohammed Akbar, "Country Perspectives: Pakistan" in *South Asian Free Trade Area: Opportunities and Challenges* (Washington, DC: USAID, 2005).

38. Niall Ferguson, *Empire: How Britain Made the Modern World* (London: Allen Lane, 2003), 53.

39. Ferguson, *Empire.*

40. Mushtaqur Rahman, *Divided Kashmir: Old Problems, New Opportunities for India, Pakistan and the Kashmiri People* (London: Boulder, 1996).

41. For a detailed chronicle of the development of the dispute and its ultimate resolution, see Aloys Mitchell, *The Indus River* (New Haven, CT: Yale University Press, 1969).

42. Victoria Schofield, *Kashmir in the Crossfire* (London: I.B. Tauris, 1996).

43. The Sterling Area was made up of the countries of British colonies that had linked their currencies to the British pound sterling. The Sterling Area is roughly equivalent today's Commonwealth.

44. For an elaboration of this view, see Shahid Javed Burki, *Pakistan: A Nation in the Making* (Boulder, CO: Westview Press, 1980).

45. The World Bank, *Trade Policy in South Asia: An Overview,* Report No. 29949 (Washington, DC, September 7, 2004), 20.

46. How Zulfikar Ali Bhutto totally restructured the Pakistani economy is analyzed in some detail in several books on Pakistan. See Shahid Javed Burki, *Pakistan Under Bhutto, 1971–77* (London: Macmillan, 1980); Shahid Javed Burki, *Pakistan: A Nation in the Making* (Boulder, CO: Westview Press, 1986); Pervez Hasan, *Pakistan's Economy at the Crossroads. Past Policies and Present Imperialists* (Karachi, Pakistan: Oxford University Press, 1998).

47. Jagdish Bhagwati, *In Defense of Globalization* (New York: Oxford University Press, 2004).

48. Joseph Stiglitz, *Globalization and its Discontents* (New York: W.W. Norton, 2002).

49. The World Bank, *The East Asian Miracle*: *Economic Growth and Public Policy* (Washington, DC, 1993).

50. World Bank, *The East Asian Miracle,* 13. Among this group of analysts was the Oxford economist Ian Little. See Ian M. D. Little, *Economic Development* (New York: Basic Books, 1982).

51. Little, *Economic Development,* table 1.6, 39.

52. The World Bank, *World Development Indicators, 2004*, 1

53. The Indian economist Jagdish Bhagwati is one of the most articulate proponents of this point of view. For his approach to international trade, Bhagwati, *In Defense of Globalization*.

54. The World Bank, *Global Economic Prospects: Trade, Regionalism and Development* (Washington, DC, October 2004), 2–12.

55. Addittyaa Mattoo and Pierre Sauve, "Regionalism and Trade in Services in Western Hemisphere: A Policy Agenda," in *Integrating the Americas,* ed. A. Estvadeodal, Dani Rodrik, Alan Taylor, and Andres Velasco (Cambridge, MA: Harvard University Press, 2004).

56. The results of the study are reported in The World Bank, *Global Economic Prospects, 2005* (Washington, DC, 2004), 5–12.

57. These models draw their name from Newtonian physics in that trade flows between two countries increase in proportion to their economic mass (as measured by their respective GDPs) and are constrained by the friction between them (proxied by the distance between them) due to the transaction and other costs.

58. See, for instance, J. A. Frankel, E. Stein, and S. J. Wei, *Regional Trading Blocs in the World Economic System* (Washington, DC: Institute for International Economics, 1997).

59. See S. Lahiri, "Controversy: Regionalism Versus Multilateralism," *The Economic Journal* 108 (1998), 1126–1127.

60. This section draws heavily on my chapter, "Potential of the South Asian Free Trade Area" in USAID, *South Asian Free Trade Area: Opportunities and Challenges* (Washington, DC, October 2005).

61. http://www.saarc-sec.org

62. Perhaps the most authoritative work analyzing the impact of SAFTA on the member states of SAARC, as well as the opportunities and challenges presented by it, is in the USAID-sponsored report referred to in note 59. This report was produced by a team of seven economists working under my supervision. I wrote the "overview" chapter of the report as well as the chapter analyzing the impact of SAFTA on Pakistan. The latter was written with the assistance of Mohammed Akbar, an economist based in Pakistan.

63. Details are from the SAARC Ministerial Declaration, January 2004.

64. These and other estimates provided in this part of the study are rough and tentative. They will have to be firmed up by experts who will use engineering and proper project analysis to come up with costs estimates.

65. Planning Commission, *Human Development Report, 2001* (New Delhi: Government of India, 2001).

66. Office of the Registrar General of India, New Delhi.

67. V. P. Rajesh, "India Suggests Greater Autonomy for Kashmir," *The Washington Post,* November 26, 2004.

68. "India and Pakistan: In from the Cold," *The Economist*, May 28, 2005, 44.

ABOUT THE AUTHOR

Shahid Javed Burki is a former vice president of the World Bank, where he worked from 1974 to 1999. He also served as finance minister of Pakistan in 1996–97. In 2004 he was at the Woodrow Wilson Center for International Scholars, where he began work on his latest book, *Historical Dictionary of Pakistan,* which was published by Scarecrow Press in 2006.

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