

# CARIS

Centre for the Analysis of  
Regional Integration at Sussex

## Qualitative analysis of a potential Free Trade Agreement between the European Union and India

### **Main Report**

### **Centre for the Analysis of Regional Integration at Sussex**

Michael Gasiorek  
Peter Holmes  
Sherman Robinson  
Jim Rollo  
Anirudh Shingal

Department of Economics  
University of Sussex  
United Kingdom

&

### **CUTS International**

Chandan Mukherjee  
Nitya Nanda  
Dr. N.C. Pahariya  
T.B.Simi

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# TABLE OF CONTENTS

<b>LIST OF ABBREVIATIONS</b> .....	<b>3</b>
<b>INTRODUCTION</b> .....	<b>10</b>
<b>1. ANALYSIS OF TRADE AND PRODUCTION STRUCTURES AND IMPLICATIONS FOR NON-TARIFF BARRIERS, SERVICES AND REGULATORY PARTS OF AN FTA</b> .....	<b>11</b>
1.1. INDIAN TRADE POLICY AND ECONOMIC PERFORMANCE.....	12
1.2. ASSESSING THE SHALLOW INTEGRATION IMPLICATIONS .....	14
1.3. DEEP INTEGRATION .....	20
1.3.1. Foreign Direct Investment .....	20
1.3.2. Trade Facilitation .....	21
1.3.3. Public-Private ownership .....	21
1.3.4. Non-tariff barriers to trade.....	22
1.3.5. Trade driven productivity change .....	23
<b>2. PROJECTED FDI AND ECONOMIC GROWTH IN INDIA</b> .....	<b>24</b>
2.1. INDIA: FDI FLOWS - POTENTIAL AND ACTUAL .....	24
2.2. MODELLING FDI FLOWS .....	25
<b>3. TRADE POLICIES IN INDIA REGARDING NON-TARIFF BARRIERS, SERVICES, AND REGULATORY ISSUES</b> .....	<b>28</b>
3.1. GOVERNMENT PROCUREMENT .....	28
3.1.1. Background and Issues .....	28
3.1.2. Data .....	29
3.1.3. Procedures & Processes in India.....	29
3.1.4. Issues for Possible Negotiation.....	29
3.2. SERVICES (INCLUDING INVESTMENT ISSUES) .....	32
3.2.1. Background and Issues .....	32
3.2.2. Data .....	32
3.2.3. Procedures & Processes in India.....	33
3.2.4. Issues for Possible Negotiation.....	33
3.3. INVESTMENT ISSUES OTHER THAN SERVICES.....	35
3.3.1. Background and Issues .....	35
3.3.2. Data .....	35
3.3.3. Procedures & Processes in India.....	35
3.3.4. Issues for possible negotiation.....	36
3.4. TRADE FACILITATION.....	38
3.4.1. Background and Issues .....	38
3.4.2. Data .....	38
3.4.3. Procedures & Processes in India.....	38
3.4.4. Issues for Possible Negotiation.....	40
3.5. TRADE DEFENCE .....	40
3.5.1. Background and Issues .....	40
3.5.2. Data .....	40
3.5.3. Procedures & Processes in India.....	41
3.5.4. Issues for Possible Negotiation.....	41
3.6. SPS AND TBT ISSUES .....	43
3.6.1. Background and Issues .....	43
3.6.2. Data .....	43
3.6.3. Procedures & Processes in India.....	44
3.6.4. Issues for possible negotiation.....	49
3.7. INTELLECTUAL PROPERTY RIGHTS .....	50
3.7.1. Background and Issues .....	50
3.7.2. Data .....	50

3.7.3. Procedures and processes.....	50
3.7.4. Issues for possible negotiation.....	52
3.8. COMPETITION POLICY .....	52
3.8.1. Background and Issues .....	52
3.8.2. Procedures and process in India.....	52
3.8.3. Issues for possible negotiation.....	52
<b>4. EU-INDIA FTA - IMPLEMENTATION ISSUES.....</b>	<b>54</b>
INTRODUCTION .....	54
4.1. GOVERNMENT PROCUREMENT.....	55
4.1.1. Overview and Scope.....	55
4.1.2. Issues for Negotiation .....	56
4.1.3. Possible Benefits and Costs .....	57
4.2. SERVICES.....	58
4.2.1. Overview and Scope.....	58
4.2.2. Issues for Negotiation .....	58
4.2.3. Possible Benefits and Costs .....	60
4.3. INVESTMENT POLICY .....	60
4.3.1. Overview and Scope.....	60
4.3.2. Issues for Negotiation .....	61
4.3.3. Possible Benefits and Costs .....	62
4.4. TRADE FACILITATION .....	63
4.4.1. Overview and Scope.....	63
4.4.2. Issues for Negotiation .....	64
4.4.3. Possible Benefits and Costs .....	65
4.5. TRADE DEFENCE.....	66
4.5.1. Overview and Scope.....	66
4.5.2. Issues for Negotiation .....	66
4.5.3. Possible Benefits and Costs .....	68
4.6. STANDARDS.....	68
4.6.1. Overview and Scope.....	68
4.6.2. Issues for Negotiation .....	69
4.6.3. Possible Benefits and Costs .....	69
4.7. INTELLECTUAL PROPERTY RIGHTS .....	70
4.7.1. Overview and Scope.....	70
4.7.2. Issues for Negotiation .....	70
4.7.3. Possible Benefits and Costs .....	71
4.8. COMPETITION POLICY.....	71
4.8.1. Overview and Scope.....	71
4.8.2. Issues for Negotiation .....	75
4.8.3. Possible Benefits and Costs .....	75

## LIST OF TABLES

Table 2.1: Percentage increase in FDI flows arising from an RTA.....	26
Table 3.1 Snapshot of customs procedures.....	38
Table 3.2: Important Ministries and Laws on Standards and Quality in India .....	45

## List of Abbreviations

<b>ACIAR</b>	Australian Centre for International Agricultural Research
<b>ACCP</b>	Accelerated Customs Clearance Procedure
<b>ACP</b>	Africa Caribbean Pacific
<b>AD</b>	Anti Dumping
<b>ADD</b>	Anti-Dumping Duty
<b>ADR</b>	Alternate Dispute Redress
<b>AGMARK</b>	Agricultural Marketing
<b>AICTE</b>	All India Council for Technical Education
<b>AIDS</b>	Acquired Immune Deficiency Syndrome
<b>AIS</b>	Automotive Industry Standards
<b>AoA</b>	Agreement on Agriculture
<b>APEDA</b>	Agricultural and Processed Food Products Export Development Authority
<b>ASCM</b>	Agreement on Subsidies and Countervailing Measures
<b>ASEAN</b>	Association of South-East Asian Nations
<b>ASSOCHAM</b>	The Associated Chambers of Commerce and Industry of India
<b>B2B</b>	Business to Business
<b>BALCO</b>	Bharat Aluminium Company Limited
<b>BCI</b>	Bar Council of India
<b>BEC</b>	Broad Economic Categories
<b>BGH</b>	Bovine Growth Hormones
<b>BHEL</b>	Bharat Heavy Electricals Limited
<b>BIMSTEC</b>	Bangladesh India Myanmar Sri Lanka and Thailand Economic Cooperation
<b>BIMSTEC</b>	Bay of Bengal Initiative for Multisectoral Technical and Economic Cooperation
<b>BIPA</b>	Bilateral Investment Promotion and Protection Agreement
<b>BIS</b>	Bureau of Indian Standards
<b>BITs</b>	Bilateral Investment Treaties
<b>BOOT</b>	Built Own Operate Transfer
<b>BOT</b>	Built Own Transfer
<b>BPO</b>	Business Process Outsourcing
<b>BST</b>	Bovine Somatotropin Hormones
<b>CAGR</b>	Compounded Annual Growth Rate
<b>CBD</b>	Conventions of Biodiversity
<b>CBEC</b>	Central Board of Excise and Customs
<b>CCI</b>	Competition Commission of India
<b>CECA</b>	Comprehensive Economic Cooperation Agreement
<b>CEEC</b>	Central and Eastern European Countries
<b>CEGAT</b>	Customs, Excise and Gold (Control) Appellate Tribunal
<b>CEM</b>	Contagious Equine Metritis
<b>CEO</b>	Chief Executive Officer
<b>CESTAT</b>	The Customs Excise and Services Tax Appellate Tribunal
<b>CFL</b>	Central Food Laboratory

<b>CII</b>	Confederation of Indian Industry
<b>CMP</b>	Common Minimum Programme
<b>CONCOR</b>	Container Corporation of India Ltd
<b>COPRA</b>	Consumer Protection Act
<b>CPC</b>	Central Product Classification
<b>CPCB</b>	Central Pollution Control Board
<b>CRS</b>	Computer and Related Services
<b>CSE</b>	Centre for Science and Environment
<b>CUTS</b>	Consumer Unity & Trust Society
<b>CVC</b>	Central Vigilance Commission
<b>CVD</b>	Countervailing Duty
<b>DBK</b>	Duty Drawback Scheme
<b>DEA</b>	Department of Economic Affairs
<b>DEPB</b>	Duty Entitlement Passbook Scheme
<b>DFIA</b>	Duty Free Import Authorization
<b>DFID</b>	Department for International Development
<b>DFRC</b>	Duty Free Replenishment Certificate
<b>DGAAD</b>	Directorate General of Anti Dumping and Allied Duties
<b>DGCI&amp;S</b>	Directorate General of Commercial Intelligence & Statistics
<b>DGFT</b>	Directorate General of Foreign Trade
<b>DGHS</b>	Directorate General of Health Services
<b>DGS&amp;D</b>	Directorate General of Supplies and Disposal
<b>DIPP</b>	Department of Industrial Policy & Promotion
<b>DMI</b>	Directorate of Marketing and Inspection
<b>DoP</b>	Department of Post
<b>DSB</b>	Dispute Settlement Body
<b>DTA</b>	Domestic Tariff Area
<b>EC</b>	European Commission
<b>ECGC</b>	Export Credit Guarantee Corporation of India Ltd.
<b>ECU</b>	European Currency Units
<b>EDI</b>	Electronic Data Interchange
<b>EEA</b>	European Economic Area
<b>EEE</b>	Electrical and Electronic Equipment
<b>EHTP</b>	Electronic Hardware Technology Park
<b>EIC</b>	Export Inspection Council
<b>EOU</b>	Export-Oriented Unit
<b>EPC</b>	Export Promotion Council
<b>EPCG</b>	Export Promotion Capital Goods
<b>EPZs</b>	Export Processing Zones
<b>EU</b>	European Union
<b>FAD</b>	Food and Agriculture Department
<b>FDA</b>	Food and Drug Authority
<b>FDI</b>	Foreign Direct Investment
<b>FEMA</b>	Foreign Exchange Management Act
<b>FHS</b>	Forum for Healthcare Standards
<b>FICCI</b>	Federation of Indian Chambers of Commerce and Industry

<b>FIEO</b>	Federation of Indian Export Organisations
<b>FII</b>	Foreign Institutional Investment
<b>FIIA</b>	Foreign Investment Implementation Authority
<b>FIPB</b>	Foreign Investment Promotion Board
<b>FK</b>	Finger-Kreinin
<b>FPO</b>	Fruits Products Order
<b>FSP</b>	Foreign Service Provider
<b>FSSA</b>	Food Safety and Standards Authority
<b>FTA</b>	Free Trade Agreement
<b>FTP</b>	Foreign Trade Policy
<b>GAIL</b>	Gas Authority of India Limited
<b>GATS</b>	General Agreement on Trade in Services
<b>GATT</b>	General Agreement on Tariffs and Trade
<b>GDP</b>	Gross Domestic Product
<b>GFCE</b>	Gross Fixed Consumption Expenditure
<b>GFR</b>	General Financial Rules
<b>GI</b>	Geographical Indicators
<b>GICI</b>	General Insurance Corporation of India
<b>GLI</b>	Grubel-Lloyd Index
<b>GPA</b>	Agreement on Government Procurement
<b>GSK</b>	GlaxoSmithKline
<b>GSP</b>	Generalized System of Preferences
<b>GST</b>	Goods and Service Tax
<b>HIV</b>	Human Immunodeficiency Virus
<b>HMO</b>	Health Management Organisation
<b>HO</b>	Heckscher-Olin
<b>HP</b>	Himachal Pradesh
<b>HRD</b>	Human Resources Development
<b>HS</b>	Harmonized System
<b>HZL</b>	Hindustan Zinc Limited
<b>ICA</b>	Indian Council of Arbitration
<b>ICAI</b>	Institute of Chartered Accountants of India
<b>ICB</b>	International Competitive Bidding
<b>ICC</b>	International Chamber of Commerce
<b>ICD</b>	Inland Container Depot
<b>ICEGATE</b>	Indian Customs and Excise Gateway
<b>ICWAI</b>	Institute of Chartered and Work Accountants of India
<b>IDF</b>	India Development Foundation
<b>IDI</b>	Indian Diamond Institute
<b>IDMA</b>	Indian Drug Manufacturers Association
<b>IEC</b>	International Electrotechnical Commission
<b>IIFT</b>	Indian Institute of Foreign Trade
<b>IIP</b>	Indian Institute of Packaging
<b>IIT</b>	Intra-Industry Trade
<b>IMF</b>	International Monetary Fund
<b>IMR</b>	Inverse Mills Ratio

<b>IPC</b>	Indian Penal Code
<b>IPCL</b>	Indian Petrochemicals Corporation Limited
<b>IPR</b>	Industrial Policy Resolution
<b>IPR</b>	Intellectual Property Rights
<b>IRDA</b>	Insurance Regulatory and Development Authority
<b>ISIC</b>	International Standard Industrial Classification
<b>ISMS</b>	Information security management systems
<b>ISO</b>	International Standardisation Organisation
<b>ISPM</b>	International Standards for Phytosanitary Measures
<b>IT</b>	Information Technology
<b>ITC</b>	International Trade Centre
<b>ITES</b>	IT-enabled services
<b>ITPO</b>	India Trade Promotion Organisation
<b>ITU</b>	International Telecommunications Union
<b>JETCO</b>	Joint Economic Trade Committee
<b>JNPT</b>	Jawaharlal Nehru Port Terminal
<b>JV</b>	Joint Venture
<b>L&amp;D</b>	Larsen & Toubro
<b>LICI</b>	Life Insurance Corporation of India
<b>LPG</b>	Liquefied Petroleum Gas
<b>LSDV</b>	Least Squares Dummy Variable
<b>M&amp;A</b>	Merger & Acquisition
<b>MA</b>	Market Access
<b>MAI</b>	Multilateral Agreement on Investment
<b>MCI</b>	Medical Council of India
<b>MDA</b>	Market Development Assistance
<b>MED</b>	Mediterranean Countries
<b>MEPO</b>	Meat Food Products Order
<b>MERCOSUR</b>	Mercado Comun del Sur
<b>MFN</b>	Most Favoured Nation
<b>MFP</b>	Ministry of Food Processing Industry
<b>MMPO</b>	Milk and Milk Product Control Order
<b>MMTC</b>	Minerals and Metals Trading Corporation of India Ltd
<b>MNCs</b>	Multinational Corporations
<b>MOCI</b>	Ministry of Commerce & Industry
<b>MOF</b>	Ministry of Finance
<b>MPEDA</b>	Marine Products Export Development Authority
<b>MRA</b>	Mutual Recognition Agreement
<b>MRL</b>	Mutual recognition licensure
<b>MRTP</b>	Monopolistic and Restrictive Trade Practices
<b>MUL</b>	Maruti Udyog Limited
<b>NABL</b>	National Accreditation Board for Testing and Calibration Laboratories
<b>NACEN</b>	The National Academy of Customs, Excise and Narcotics
<b>NAFTA</b>	North American Free Trade Agreement
<b>NAMA</b>	Non-Agriculture Market Access
<b>NASSCOM</b>	National Association of Software and Service Companies

<b>NCTI</b>	National Centre for Trade Information
<b>NELP</b>	The New Exploration Licensing Policy
<b>NGO</b>	Non Government Organisation
<b>NIC</b>	National Informatics Centre
<b>NPA</b>	Non-performing Asset
<b>NSIC</b>	National Small Industries Corporation
<b>NTB</b>	Non-Tariff Barriers
<b>NTPC</b>	National Thermal Power Corporation
<b>OBS</b>	Other Business Services
<b>OCS</b>	Other Commercial Services
<b>OECD</b>	Organization of Economic Cooperation and Development
<b>OFDI</b>	Outward Foreign Direct Investment
<b>OLS</b>	Ordinary Least Squares
<b>ONGC</b>	Oil and Natural Gas Commission
<b>PCI</b>	Per Capita Income
<b>PCT</b>	Patent Cooperation Treaty
<b>PCY</b>	Per Capita Income
<b>PEC</b>	Projects & Equipment Corporation of India Ltd
<b>PESO</b>	Petroleum and Explosives Safety Organisation
<b>PFA</b>	Prevention of Food Adulteration Act
<b>PKI</b>	Public Key Infrastructure
<b>PMO</b>	Prime Minister's Office
<b>PPL</b>	Paradeep Phosphate Limited
<b>PPP</b>	Public Private Partnership
<b>PSE</b>	Public Sector Enterprise
<b>PSU</b>	Public Sector Undertaking
<b>QAG</b>	Quality Assurance Group
<b>QCI</b>	Quality Council of India
<b>QR</b>	Quantitative Restrictions
<b>QUAD</b>	United States European Union Canada and Japan
<b>R&amp;D</b>	Research and Development
<b>R&amp;R</b>	Resettlement and Rehabilitation
<b>RBI</b>	Reserve Bank of India
<b>RC</b>	Rate Contract
<b>RCA</b>	Revealed Comparative Advantage
<b>RDSO</b>	Research Design & Standards Organization
<b>RIS</b>	Research and Information System for the Non-Aligned and other Developing Countries
<b>RITES</b>	Rail India Technical & Economic Services
<b>RMS</b>	Risk Management System
<b>ROHS</b>	Restriction on Hazardous Substances
<b>RoO</b>	Rules of Origin
<b>RT</b>	Rules of Thumb
<b>RTA</b>	Regional Trade Agreement
<b>RTI</b>	Right to Information Act
<b>S&amp;DT</b>	Special & Differential Treatment

<b>SAARC</b>	South Asian Association for Regional Cooperation
<b>SAD</b>	Special Additional Duty
<b>SAFTA</b>	South Asia Free Trade Area
<b>SAR</b>	South Asia Region
<b>SDR</b>	Special Drawing Rights
<b>SEBI</b>	Securities and Exchange Board of India
<b>SEZ</b>	Special Economic Zones
<b>SIA</b>	Secretariat for Industrial Assistance
<b>SIONs</b>	Standard Input-Output Norms
<b>SITC</b>	Standard International Trade Classification
<b>SME</b>	Small and Medium Enterprise
<b>SPS</b>	Sanitary and Phytosanitary Measures
<b>SSI</b>	Small Scale Industry
<b>STC</b>	State Trading Corporation
<b>STCL</b>	Spices Trading Corporation of India Limited
<b>STPs</b>	Software Technology Parks
<b>TBT</b>	Technical Barriers to Trade
<b>TDCA</b>	Trade, Development and Cooperation Agreement
<b>TF</b>	Trade Facilitation
<b>TIDP</b>	Trade and Industry Development Project
<b>TK</b>	Traditional Knowledge
<b>TKDL</b>	TK Digital Library
<b>TRAI</b>	Telecom Regulatory Authority of India
<b>TRAINS</b>	Trade Analysis & Information System
<b>TRIMs</b>	Trade Related Investment Measures
<b>TRIPS</b>	Trade Related Intellectual Property Rights
<b>TUPE</b>	Transfer of Undertakings and Protection of Employees
<b>UGC</b>	University Grants Commission
<b>ULCRA</b>	Urban Land (Ceiling & Regulation) Act
<b>UN Comtrade</b>	United Nations Commodity Trade Statistics
<b>UNCTAD</b>	United Nations Conference on Trade & Development
<b>UNECE</b>	United Nations Economic Commission for Europe
<b>UNESCAP</b>	United Nations Economic and Social Commission for Asia and the Pacific
<b>UPA</b>	United Progressive Alliance
<b>UPOV</b>	The International Union for the Protection of New Varieties of Plants
<b>UR</b>	Uruguay Round
<b>USD</b>	United States Dollar
<b>USO</b>	Universal Service Obligations
<b>USTR</b>	United States Trade Representative
<b>UTPS</b>	Unfair Trade Practices
<b>VCD</b>	Video Compact Discs
<b>VGf</b>	Viability Gap Funding
<b>VRS</b>	Voluntary Retirement Schemes
<b>VSNL</b>	Videsh Sanchar Nigam Limited
<b>WB</b>	World Bank
<b>WEEE</b>	Waste Electrical and Electronic Equipment

**WHO**  
**WIPO**  
**WTO**

World Health Organization  
World Intellectual Property Organization Copy Right Treaty  
World Trade Organization

## Introduction

This study on the potential implications of a free trade agreement between the EU and India is composed of four principal elements. These are:

1. An analysis of trade and production structures in India and the EU: implications for non-tariff barriers, services and regulatory parts of an FTA
2. Projected FDI and economic growth in India
3. Trade policies in India regarding non-tariff barriers, services and regulatory issues; nature of the main obstacles to trade and the implications for the scope and content of an FTA.
4. Implications of deep integration under an FTA between India and the EU, in terms of both potential legislation and implementation issues within India's administrative system

With respect to each of these elements, there is a detailed Annex, which provides the substantive analysis and discussion. In this main body of the report we have summarised the principal findings and conclusions derived from that detailed work. For a full discussion of the issues the reader should consult the Annexes themselves.

# **1. Analysis of trade and production structures and implications for non-tariff barriers, services and regulatory parts of an FTA**

This part of the study provides an analysis of some of the key issues arising from a potential EU-India FTA through an examination of key diagnostic indicators for India and the EU, drawing directly on the methodology in the Sussex Framework. The central features of the Sussex Framework involve the identification of those issues which need to be borne in mind in evaluating a potential RTA, and then using appropriate indicators for such an evaluation<sup>1</sup>.

In the first instance, preferential trade liberalisation involves a process of shallow integration. Shallow (or negative) integration can be defined as the removal of border barriers to trade, typically tariffs and quotas. As is well known, the potential net benefits from shallow integration are inherently ambiguous. This arises because of the likelihood of both trade creation (which is welfare increasing) and trade diversion (which is welfare reducing). Trade creation arises when more efficiently produced imported goods from the new partner country replace less efficient domestically produced goods. Trade is “created” and yields welfare gains. Trade diversion occurs when sources of supply switch away from more efficient non-partner countries to less efficient partner countries. This arises because the less efficient partner countries gain tariff-free access within the RTA and may be able therefore to undercut more efficient non-partner countries. Trade diversion therefore reduces welfare. The net welfare impact of an RTA will depend on the relative size of the two effects.

In addition to these effects, there may be further welfare gains arising from the induced growth effects stimulated by, for example, productivity growth, increased specialisation, and/or positive externalities between firms, sectors or across sectors (e.g. between manufacturing and services) which are typically more likely to arise in the presence of deeper integration. In contrast to shallow integration, “deep” (or positive) integration involves policies and institutions that facilitate trade by reducing or eliminating regulatory and behind-the-border impediments to trade, where those impediments may or may not be intentional. These can include issues such as customs procedures, regulation of domestic services production that discriminate against foreigners, product standards that differ from international norms or where testing and certification of foreign goods is complex and perhaps exclusionary, regulation of inward investments, competition policy, intellectual property protection and rules surrounding access to government procurement.

In assessing an RTA it is therefore crucial to first identify the implications arising from the implied shallow integration and then building upon this to consider the possible role and importance of measures of deeper integration. This part of the report is therefore

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<sup>1</sup> In the report the term RTA is employed when referring generically to a preferential trading arrangement between countries. The term FTA is used wherever the arrangement under consideration is that of a free trade area.

divided into three sections, which build closely on the key features of the Sussex Framework. First, we detail the underlying policy environment in India, as well as identify key aspects of the Indian economy and its evolution over time. Secondly, we focus on existing and historical patterns of trade both by sector and by partner country and use selected indicators in order to identify the likelihood for both trade creation and trade diversion. Lastly, we turn to the issue of deep integration and consider qualitative and quantitative evidence which can shed light on the potential welfare gains which could arise from deeper integration.

### **1.1. Indian Trade Policy and Economic Performance**

Indian trade policy was extremely protectionist in the years 1950-1975 such that by the end of that period, the Indian economy was virtually autarkic. From the mid-1970s onwards there was a period of partial and intermittent liberalisation with an accelerating trend during the 1980s. It was not, however, until 1992 that coherent and comprehensive trade reform in favour of a more outward oriented, market based economy began to be implemented. The current Foreign Trade Policy (FTP) 2004-09 is built around the objectives of doubling India's share of global merchandise trade by 2009 and using trade policy as an effective instrument of economic growth with a strong emphasis on employment generation. The policy aims at removing controls, bringing down transactions costs, and identifying key areas in order to develop India as a global hub for manufacturing, trade and services. An important component of the policy is the greater integration of the Indian economy into the world economy via the multilateral process, but also increasingly through regional trading arrangements.

Hence India has already entered into a number of framework agreements for preferential trade agreements. The recently concluded Comprehensive Economic Cooperation Agreement (CECA) with Singapore was implemented from 1<sup>st</sup> August 2005. Member countries of South Asian Association for Regional Cooperation (SAARC) signed the Agreement on South Asia Free Trade Area (SAFTA) in January 2004. A Framework Agreement on Comprehensive Economic Cooperation between ASEAN and India, a Framework Agreement for a Bangladesh, India, Myanmar, Sri Lanka and Thailand Economic Cooperation (BIMSTEC) FTA in goods, services and investment is under negotiation and an India-Thailand Framework Agreement has also been signed. Finally, India-China, India-Japan, and India-South Korea joint study groups have been established.

India's import licensing system was largely abolished in 1991, though it initially continued primarily for some consumer goods. Tariffs over 1990-2005 were substantially reduced from an average of just under 79% to 17%. These reductions were fairly uniform across sectors with the highest tariffs still applying to Beverages and Tobacco, and the smallest reductions in tariffs for Food and Live Animals (from 55.1% to 36.9%). Manufactured Goods, Machinery and Transport Equipment experienced the largest decline in tariffs with average tariffs in 2005 of around 15%. The decline in tariffs has been reflected in the increased openness of the Indian economy, which has seen the share of exports of goods and services to GDP rise from 7.3% (1990) to 13% (2000) to 19%

(2004), and similarly the share of imports of goods and services to GDP rising from 9.9% to 14% to 21%. While looking at average tariff rates is important, the averages can mask particularly high tariffs in given sub-sectors or tariff lines. Such high tariffs on particular commodities are known as tariff peaks. When looking at tariff peaks we find that there are comparatively few tariff peaks in India (where less than 1% of the tariff lines had tariff peaks), in comparison to the EU (over 10% of tariff lines). However, where the peaks exist they are typically much higher in India than in the EU. In India they range from 15% to 160%, whereas in the EU they range from 0.21% to 52.4%.

In addition to tariff barriers in the pre-1991 period, India used a number of schemes for both export promotion and import restriction. The majority of the import restriction schemes were eliminated as a consequence of the import liberalization policy introduced after 1991. However, there are duty exemption schemes which enable duty free imports of inputs required for export promotion. Currently export prohibitions are applicable to only a small number of items mainly on health, environmental or moral grounds. Export restrictions (quantitative/ceiling/canalisation) are currently applicable to cattle, camels, cereals, fertilizers, groundnut oil, pulses, petroleum products etc.

The signing of a FTA between the EU and India therefore implies a more substantial change in tariffs for India than for the EU, and consequently more structural adjustment. The greater degree of structural adjustment will occur not simply because of the higher average tariff levels in India, but also because of the far greater importance of the EU in Indian trade in comparison to the importance of India in the trade of the EU. Assuming all sectors were included, the biggest impact would fall on Food, Beverages and Tobacco, and on Animal and Vegetable Oils, as these are the sectors currently with the highest tariffs, and in many cases also with the highest tariff peaks. Outside of this, there are a few industries in which tariff peaks appear to be important, such as HS87 (Vehicles other than (o/t) railway/trams, rolling stock, parts and accessories), HS55 (man-made staple fibres), HS39 (Plastics and articles thereof), HS52 (Cotton), and HS38 (Miscellaneous chemical products). These are all sectors which are therefore likely to be more resistant to tariff reductions under an FTA. Of course it is far from clear that all sectors would necessarily be included in an FTA, as the WTO requirement stipulates only that “substantially all trade” be covered. Service sector liberalisation is more difficult and complex, largely due to internal political factors within India. For example, opening up the retail sector is controversial as opponents argue that liberalisation will destroy the livelihoods of millions of small rural traders put out of business by foreign retail firms.

Since independence in 1947, India has achieved neither the ‘miracle’ growth rates of neighbouring East and Southeast Asian nations, nor prolonged periods of stagnation and/or decline as experienced by some African and Latin American countries. Instead growth has been relatively stable, averaging roughly 3.5% per annum until the early 1980s, and accelerating somewhat after the reforms of the early 1990s. The rapid growth of India in the eighties and nineties was accompanied by a reduction in poverty and a substantial growth in GDP per capita based on purchasing-power-parity. While there is some debate as to the precise causes driving the relatively high growth rates experienced by India over the last decade or so, it is clear that both trade liberalisation and domestic

economic reforms played an important role. From the perspective of the EU, and the possible FTA with India, it is clear that India is a large, rapidly growing, and increasingly successful economy – hence its potential importance as a trading partner for the EU.

The structure of the Indian economy has seen growth in the importance of services in GDP. Its share rose from around 15% of GDP in 1950, to over 26% in 2005. Interestingly, half of this increase occurred during the nineties. The share of industry has also risen, from 15% to 26%. Corresponding to this increase in services, it is agriculture which has seen its share of GDP decline substantially from close to 60% in 1950 to around 20% in 2005. The decline in the share of agriculture has continued over the last decade or so. Despite the fact that considerable changes have taken place in economic policy and the pattern of manufacturing imports and exports (both internally and with regard to the external trade regime), there is a large degree of stability in the Indian manufacturing structure. This is no doubt due to the large size and degree of diversification of the Indian economy.

## ***1.2. Assessing the Shallow Integration Implications***

As discussed earlier, preferential trade liberalisation such as an FTA between the EU and India involves at the very least a process of shallow integration, and may include elements of deep integration. The net benefits from shallow integration are inherently ambiguous because of the likelihood of both trade creation (welfare increasing) and trade diversion (welfare reducing). In addition to these effects there may be further welfare gains arising from the induced growth and productivity effects which are more likely to arise in the presence of deeper integration.

The prospective EU-India FTA will bring about the removal of tariffs on a preferential basis, which leads to both trade creation and trade diversion. There are two possible channels of trade creation. First, this can arise when more efficiently produced imported goods replace less efficient domestically produced goods. Thus, on the production side, trade is “created” and yields welfare gains. Secondly, even assuming no changes in domestic production, a reduction in tariffs that leads to a reduction in prices will increase demand for goods which were already previously imported from the partner country. This too leads to welfare gains as consumers have access to cheaper goods than previously. Here trade is “created” on the consumption side.

Trade diversion occurs when sources of supply switch away from non-FTA partner suppliers to the new FTA partner. If, prior to the FTA, the MFN levying country chose to import from the non-FTA supplier, this would have occurred because that supplier was more efficient (cheaper) than the alternatives. If the formation of the FTA results in a switch to the new partner country that involves moving the source of supply away from the more efficient supplier and towards a less efficient (FTA partner country) supplier, then trade diversion is considered to involve a welfare loss. Note that the welfare loss is experienced here by the importing country, who is switching to the less efficient supplier. However, there is a potential welfare gain to the FTA partner country who is exporting more as a result of this switch. The gain is only potential as it depends on whether the

partner country was initially at full employment or not. If the partner country was previously in full employment, the FTA results in an increased demand for some of its goods, but this would then involve a reallocation of resources from one sector to another, as opposed to resulting in a net expansion of resources in the economy.

The key point which emerges from the preceding analysis is that preferential liberalisation will impact on trade flows through trade creation and trade diversion, but the net welfare effect from that reallocation of trade flows is inherently ambiguous. There are a number of important rules of thumb, as identified in the Sussex Framework, which can be employed in order to shed light on the likely shallow integration impact of a Free Trade Agreement between the EU and India. These rules of thumb (RTs) are clearly interrelated and are listed below (in no particular order of importance):

1. ***The higher are the initial tariffs / barriers***, the greater are the likely effects on both trade creation and trade diversion. With high initial (MFN) tariffs, the greater is the initial distortion. This in turn means that in principle there is greater scope for both trade creation and trade diversion as those tariffs are preferentially removed. Hence if the pre-RTA tariffs were very high, as these are removed it is more likely that the new partner country may be able to supply the good more efficiently than the domestic economy. The higher the pre-RTA tariffs, the more likely it is that this will be the case and consequently, the greater the possibility for such trade to be created. Moreover, the higher the pre-RTA tariff, the greater the price reduction arising from its removal, which in turn increases the demand for the good and creates more trade. Each of these process of trade creation are welfare increasing. However, it is also the case that if pre-RTA tariffs were high, then as they are removed there is a greater possibility of the new RTA partner countries supplying the (tariff free) good cheaper than can the non-RTA partners (on whose exports tariffs are levied). Hence, even though the non-RTA partners may produce the good more efficiently and cheaply, the good will be supplied by the RTA partner who has preferential access to the market. The higher the pre-RTA tariffs, the more likely it is that this form of welfare reducing trade diversion will occur.
2. ***The greater the number of RTA partners***, the more likely it is that there will be trade creation as opposed to trade diversion, because of the increased likelihood of including more efficient suppliers. By way of illustration, suppose that a given trade agreement were to include the maximum number of possible countries. At the limit this would include all the countries in the world, and hence by definition the most efficient countries will have been included. Therefore, including a greater number of countries in an RTA minimises the extent of trade diversion, and simultaneously maximises the likelihood of trade creation.
3. ***Wide differences in comparative advantage*** between partner countries are likely to lead to a welfare improving RTA. Trade creation occurs when there are differences in efficiency and costs across partner countries – hence the RTA enables the partners to source the goods from the most efficient RTA partner. The greater those differences in comparative advantage (and hence in costs across the

- countries) the greater is the likely gain from trade creation. If India is only marginally more efficient than the EU in producing a given good, then the gain to the EU from importing the good from India as opposed to producing it itself is relatively small. However, if India is significantly more efficient than the potential gains are that much higher. It is worth noting, however, that if the initial tariffs are high then, as detailed in the first rule of thumb, there is also greater likelihood of trade diversion which diminishes the trade creation gains.
4. ***The more similar the product mix*** in the economies concerned and the higher the elasticities of supply, the greater the possibility of trade creation. Recall that trade creation occurs when the importing country produces less of the good itself and instead imports the good from its RTA partner. Suppose that prior to the RTA there was no overlap whatsoever between the two countries' production bundles. If that were the case then the only possibilities for trade creation would arise on the demand side. Conversely, if there is a significant overlap in the goods produced by the partner countries, there is much more scope for switching sources of supply to the more efficient country. Note also that assuming a given degree of overlap in the production structures, the more responsive supply is to the tariff reduction-induced changes in prices, the greater the extent of trade creation.
  5. ***The higher the percentage of trade with potential partners***, the greater the possibility of the RTA enhancing welfare. Consider an initial situation where there was very little trade with the potential partner country. This would suggest that in the initial situation, third countries were more efficient suppliers. An RTA is therefore more likely to result in trade diversion under these circumstances. Conversely, if in the initial situation the countries traded significantly with each other, it is more likely that they are each respectively importing from the more efficient supplier, and the chances of trade diversion occurring are lessened.

The first rule of thumb focuses on the initial tariff and/or trade barrier structure. In the section devoted to Indian Trade Policy in Annex 1, we show that in many manufacturing sectors, while Indian tariffs have declined considerably, the average tariff is still quite high at around 15%. Certain sectors are still considerably more protected (Food, Beverages and Tobacco, and Animal and Vegetable Oils), and several other sectors exhibit significant tariff peaks. All this suggests that the existing levels of distortion are quite high; therefore, in liberalising Indian tariffs on EU exports, there is considerable likelihood of there being both trade creation and trade diversion into the Indian economy. The net welfare effect for India is likely to be ambiguous and will depend in good part on a more careful consideration of the other rules of thumb.

In contrast, for the most part EU tariffs are already low although they exhibit a greater incidence of tariff peaks, which in certain cases can also be quite high. There would consequently appear to be less scope for significant trade creation and trade diversion for the EU. However, this of course depends on the underlying elasticities of supply, and also on the extent to which small tariffs impact on differences in competitiveness across countries. Again, this needs to be considered in the light of the other rules of thumb.

Consider first the number of countries involved in the proposed FTA (RT2). From the perspective of the EU there is clearly only one partner country, while India would be signing an agreement which involves 27 countries. In addition, depending on the cumulation arrangements, the FTA could also involve decreasing barriers to trade with all those countries with which the EU has other agreements, such as those in the Southern Mediterranean. Thus it would seem that, for those goods in which the EU does not have a comparative advantage, signing an FTA with a single country – India – increases the likelihood of trade diversion and lessens any trade creation welfare gains. In contrast, India would be signing an agreement with a larger number of partner countries, where the initial level of trade between them is already high. This indicates greater potential for trade creation. To explore this further we need to look more carefully at the geographical distribution of trade.

The extent to which the partner countries trade with each other prior to the free trade agreement is the essence of RT5. From the EU's perspective, India accounts for around 1.5% of both exports and imports of goods to and from the European Union in 2004. This share has increased gradually over the last fifteen years, starting at around 1% in 1990. What is clear is that trade with India is relatively small, though growing. It is also the case that the EU's tariffs are typically fairly low on Indian exports. All this suggests that the scope for trade creation – be it with regard to production or consumption – is relatively small, while there is clearly scope for trade diversion. Thus for the EU, the shallow integration-induced welfare effects are likely to be small, and the sign of the net effect ambiguous. It is of course possible that, given the relative size of the Indian economy, its growth, and the expansion of its imports and exports, in the future India may well become a more significant market for the EU as well as a potentially significant supplier into the EU market. For this to be the case, however, would require a fairly substantial break from current trends.

Currently India's most important trading partner is the European Union, which accounted for 25% of imports in 2004. The United States accounts for 9% of Indian imports (with petroleum products excluded). The Middle Eastern countries provide 8% of imports, and South-East Asia 14%. Clearly, the EU is an important supplier, which suggests that there is likely to be some scope for trade creation arising from a future FTA.

In the discussion above we outlined how trade creation could occur either on the production side (ie trade displacing domestic production), or on the consumption side (increased imports arising from lower partner country prices). The extent to which the former will occur depends on the degree of overlap in production and trade structures across the two economies, and on the differences in relative costs of production between the EU and India (RT3 and RT4). To measure the degree of similarity between the two partners, we used the Finger-Kreinin index.<sup>2</sup> The FK index is equal to one when the

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<sup>2</sup> This is an index which is designed to capture the degree of similarity between a pair of countries either with regard to trade or production structures. Ideally we would like to be able to compute the index on patterns of production as that is the most direct way of addressing the fourth rule of thumb. However, the data is not available. Following common practice we compute the index on the basis of trade flows, and use

structure of trade (defined by the share of each sector in total trade) across the two countries being compared is identical and is equal to zero when the structure of trade is completely different. If we compare EU and Indian exports, the FK index is relatively low at 0.24. This suggests that in terms of the export structure, the EU and India are fairly dissimilar.<sup>3</sup> This would appear to suggest that on the production side there is not much evidence of scope for trade creation.

It is also important to consider the relative competitiveness of producers across the countries in the FTA as suggested by the RT3. This we do by calculating indices of revealed comparative advantage. The RCA measures a country's exports of a commodity relative to its total exports and the compares this to the world exports of a commodity relative to total world exports. A comparative advantage is "revealed" if  $RCA > 1$ . This is because the index shows that the country is exporting a higher share of the good than the share of the good in world exports – hence the country has a comparatively higher share for that good, implying a comparative advantage. Analogously, if the RCA is less than unity, the country is said to have comparative disadvantage in that commodity. We calculate the RCAs for both India and the EU at the HS 6-digit level - which accounts for approximately 4500 different commodities.

In this analysis we first compared the RCAs for the top fifteen exporting sectors for each country. Although focusing only on a small number of industries, it appears that there is little similarity in patterns of comparative advantage between the EU and India. Next we computed the correlation coefficient between the EU and India RCA as  $-0.18$ . From this one can conclude that the pattern of underlying comparative advantage between the EU and India is considerably different. Where there is overlap in their production bundles, this would appear to suggest that there is some scope for trade creation on the production side. However, as discussed above, there does not appear to be too much overlap in this regard (as captured by the Finger Kreinin indices), and thus relatively little scope for trade creation.

In addition, we need to consider the possibilities for trade diversion. Despite the fact that the EU accounts for 25% of Indian imports, the majority of India's imports are sourced from outside the EU, which thus suggests that there is also considerable scope for trade diversion. Clearly it is unrealistic to suppose that the EU is competing here with all the

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trade flow similarity as an imperfect proxy for production structure similarity. This index was computed at the 6-digit level of disaggregation.

<sup>3</sup> For comparison the FK index for EU and US exports is equal to 0.6.

other suppliers. It is only in a subset of products which the EU has a comparative advantage, and across a range of products and suppliers (e.g. oil) there will be little trade diversion. Nevertheless, the US already supplies 9% of India's imports, and many other OECD countries and increasingly China are likely to be competing with EU producers. We also compared India's imports from the world with India's imports from the EU using the Finger-Kreinin index. In this case the index is quite high at 0.42 including petroleum products, and 0.53 excluding petroleum. This suggests that EU exports into India compete with exports from other countries into India. Giving the EU a preferential margin (i.e. tariff free access) with respect to the Indian market reinforces the conclusion suggested earlier pointing to the possibility of trade diversion arising from an EU-India FTA.

The overall conclusion from this discussion, therefore, is that for India there are possibilities for trade creation. These are likely to arise from the possibility for cheaper imports from the EU. However, as only 25% of India's imports come from the EU, the scope for such trade creation on the consumption side is relatively limited. Similarly, the lack of similarity between the production structures in the EU and India suggests there is little scope for trade creation on the production side, while there is considerable scope for trade diversion, so the net welfare effect for India is therefore clearly ambiguous. To the extent that such trade diversion occurs, from the EU's perspective, this implies an increase in demand for EU goods arising from the expansion of the EU's exports to India. As discussed earlier, whether this entails a net positive welfare effect for the EU will depend on whether the expanding sectors are being matched by contracting sectors elsewhere, or whether the expansion is using previously unemployed resources. Of course, there will be gains for the sectors which experience a trade-diverting increase in demand. There is another interesting feature of EU-India trade which emphasises our conclusions with regard to trade diversion. This concerns the declining share of the EU in India's imports. That share declined from over 40% in the early 1990s to 25% in 2004. This is reinforced by our decile analysis, which indicates the increasing diversification of India's imports. This suggests that under an MFN regime India's pattern of imports was shifting away from the EU towards other countries. The signing of an FTA may well decelerate or reverse this trend – but to the extent that this is trade diversion-induced then the above considerations apply.

From the EU's perspective, while clearly India is an important destination market, it currently only accounts for 1.3% of the EU's exports. Nevertheless, as the share of the EU in Indian imports has significantly decreased over time, this might suggest the increasing competitiveness of third country suppliers. Once again, this suggests however, that while an FTA may well serve to increase the share of the EU in the Indian market this is likely to cause trade diversion as well. Of course, to some extent this will be mitigated by any trade creation that takes places, and given the share of the EU in India's imports there is clearly some scope for this too. From the perspective of Indian exports to the EU, there is a likelihood of some trade diversion, and possibly some trade creation, though this is unlikely to be significant given the existing low share of Indian exports in EU imports.

### **1.3. Deep Integration**

In considering the possible impact of an EU-India FTA, it is important to consider not just the implications of the removal of tariff barriers, but also the implications of the removal of non-tariff barriers and the opportunities for positive integration or deeper integration. These may deal, for example, with regulatory harmonisation, with investment rules, with liberalisation of services, and with measures of trade defence. The welfare gains from a process of deeper integration are likely to be considerably higher than those derived simply from a process of shallower integration. The possible range of further gains often associated with deeper integration include: technology transfer and diffusion both through trade and FDI; pro-competitive gains from increasing import competition in an environment of imperfect competition, which may also allow greater exploitation of economies of scale in production; the increased geographical dispersion of production through trade that supports (i) exploitation of different factor proportions for different parts of the production process (Ricardian efficiency gains) and/or (ii) local economies of scale through finer specialization and division of labour in production (“Smithian” efficiency gains); and externalities arising from institutional changes that lead to wide increases in productivity.

It is more likely that the potential for deeper integration gains will be achieved the greater is the realisation of a “common economic space” as a result of the FTA. This common economic space requires both removal of barriers to trade that operate beyond borders (e.g. discriminatory taxes and regulations) and action to undertake common policies needed for dealing with the existence of public goods and externalities. Of course, the impact of deep integration will clearly depend on whether the norms adopted are appropriate — i.e., generate positive externalities and promote trade. Broadly speaking, adopting appropriate standards is synonymous with finding the appropriate institutional framework for dealing with externalities.

#### **1.3.1. Foreign Direct Investment**

FDI plays an important role in generating additional gains from deep integration. This is because FDI is an important channel for productivity change via technology and know-how transfers, quality improvement and specialisation. Reforms with regard to FDI have been extensive in India from 1991 onwards. Today, barring a few areas, foreign investment in India can be made in all sectors under the Automatic Route under which foreign investors only need to inform the Reserve Bank of India within 30 days of bringing in their investment and within 30 days of issuing any shares. In most sectors, foreign investment is permitted up to 100% of the paid up capital. Only in some areas is investment subject to sectoral caps on account of security/strategic/sectoral considerations. FDI up to 100% has been permitted under the Automatic Route for drug and pharmaceutical manufacturing, the hotel and tourism sector, and for Mass Rapid Transport Systems in all metropolitan cities, including associated commercial development of real estates. A new Auto policy has been unveiled, which does away with indigenization requirements or trade balancing obligations and allows foreign equity investments up to 100% under automatic approval. Investment up to 100% is also permitted with government permission in airports, for development of integrated townships, city and regional level urban infrastructure facilities such as roads and

bridges, and manufacture of building materials, and in courier services (subject to exclusion of activity relating to distribution of letters). FDI up to 49% from all sources is permitted in the banking sector on the automatic route.

Recently the government has also approved the partial opening of retail markets to foreign investors by allowing 51% FDI in single brand products. Besides retail, other sectors are being opened which include: 100 percent FDI allowed in new sectors such as power trading, processing and warehousing of coffee and rubber; FDI limits raised to 100 percent under automatic route in mining of diamonds and precious stones, development of new airports, cash and carry wholesale trading and export trading, laying of natural gas pipelines, petroleum infrastructure, captive mining of coal and lignite. Subject to other regulations, 100 percent FDI is allowed in distilling and brewing of potable alcohol, industrial explosives and hazardous chemicals. In addition to the preceding, Indian investors are now allowed to transfer shares in an existing company to foreign investors, and the limit to telecom services firms has been raised to 74 percent from 49 percent.

The investment scenario is rapidly changing and India is increasingly considered a stable country for investment. More and more countries and international firms are looking to invest in India. The UNCTAD considers India a “dominant host country” for FDI in Asia and the Pacific. India attracted over three times more foreign investment (US\$ 7.96 billion) during the first half of 2005-06 than it received during the corresponding period of 2004-05 (US\$ 2.38 billion).

### **1.3.2. Trade Facilitation**

There are a large number of bodies/agencies dealing with different aspects of trade facilitation in India. The principal bodies are listed in the Annex to this part of the report, where we also describe their main functions. Annexes 3 and 4 of the report focus on the trade facilitation barriers which may exist in India, identifying issues of concern and areas which might be dealt with in the context of an EU-India FTA.

### **1.3.3. Public-Private ownership**

The public sector has historically played an important role in India through the building of infrastructure for economic development, the creation of employment opportunities and self-reliance through the development of industries – especially in the heavy and capital-goods intensive sectors. However, excessive dependence on this sector and its monopoly power with excessive governmental controls resulted in well-known problems of inefficiency and poor levels of productivity and profitability. In the early 1990s, the share of the public sector in GDP at factor cost was just over 25%. In recognition of the inherent inefficiencies in the public sector, a policy of privatisation was introduced in the early 1990s. While that policy has resulted in fairly substantial divestments in the public sector, the share of the public sector in Indian GDP nevertheless remains fairly high. The public sector is particularly important in mining and in electricity, gas and water supply, where the shares in 2004 were respectively 93% and 86% respectively. In manufacturing, the share of the public sector has declined from 24% in 1994 to just over 11% in 2004.

By examining the net capital stock in industry and the share of the public sector during the post-liberalisation period between 1994 and 2004, it is clear that the dominance of the public sector in mining and electricity continued to persist even after industrial liberalisation and opening of these sectors to private sector participation. There is hardly any perceptible fall in the share of the public sector in the net capital stock of mining and electricity enterprises. In contrast the share of the public sector in manufacturing declined from 24.1% in 1994, to 11.72% in 2004 (see Table 4.1 in Annex 1).

Currently the government is committed to a strong and effective public sector whose social objectives are also to be met by its commercial functioning. The United Progressive Alliance (UPA) have pledged to devolve full managerial and commercial autonomy to successful, profit-making companies operating in a competitive environment. Generally, profit-making companies are not to be privatized. While every effort will be made to modernise and restructure sick public sector companies and revive sick industry, chronically loss-making companies will either be sold off or closed.

#### **1.3.4. Non-tariff barriers to trade**

We consider non-tariff barriers to trade in two ways in this report. First, we extract the relevant data on Indian NTBs from the work of Kee, Nicita and Olearraga, and consider the extent of non-tariff barriers and non-tariff barrier peaks. Secondly, we have constructed a detailed database which comprises all the reported cases of barriers to trade and investment in India derived across a range of sources and databases.

From the NTB dataset we see that tariff peaks are present in almost all of the HS-2-digit industries, and thus are much more widespread than was the case with respect to tariffs. The average tariff-equivalent of the estimated NTBs is just over 18% at the HS 2-digit level, and for comparative purposes, the average tariff across the same categories is just over 20%. Not surprisingly, this suggests that looking at tariffs alone potentially tends to underestimate the true level of protection by about 50%. It is also worth noting that there is only a mild correlation, however, between tariffs at the sectoral level, and their NTB tariff-equivalents, with a correlation coefficient of approximately 0.15.

The analysis suggests that there are considerable non-tariff barriers to trade in India, and that while the average non-tariff barrier is similar to the average tariff levels in India, there is considerable variation within given HS 2-digit categories. This is reflected in the fact that the average tariff in the peaks is typically very high, and in over 27 cases is above 100%. This in turn suggests that non-tariff protection in India appears to be highly product (or tariff heading-line) specific. To the extent that the Kee et al. dataset accurately reflects the underlying non-tariff barriers to trade, these are considerable in the Indian economy, and are therefore likely to lessen the possibility of future deep integration gains from shallow policy measures alone. From a policy perspective, therefore, this suggests the need to remove as many of such impediments to trade as possible.

The second way in which we consider the presence of non-tariff barriers to trade in India is by compiling a database of all known cases of reported problems with regard to trade

with India. For this database we have used a wide range of sources, such as the EU market access database, WTO cases or US trade barriers reports. Using these, we gain valuable insights into particular cases and groupings of cases.

From the database, it appears that a substantial proportion of the EU's exports to India are covered by some form of non-tariff barrier to trade. If we include all barriers and all industries, the figure is just over 41%. However, this figure is inflated by the inclusion of the general category machinery (where the underlying complaint was with regard to second hand machinery). If this category is excluded, approximately 10% of EU exports are covered. This is still a substantial figure, and underlines the reasons why the EU is concerned about such NTBs in India. The discussion also showed that in a large proportion of cases, NTBs are being levied in those industries where the EU has a revealed comparative advantage while India does not.

### **1.3.5. Trade driven productivity change**

A key indicator of existing deep integration is the degree to which intra-industry trade (IIT) is taking place. Equally, the rate of growth of IIT is an indicator of the potential for further deep integration. Broadly, IIT takes three forms. First, it is the exchange of similar goods (with the same trade heading) of roughly similar qualities and prices; secondly, it is the exchange of similar goods of different qualities and prices; thirdly, it is the exchange of goods within a trade classification that represents a vertically integrated supply chain (parts for finished or partly finished goods). Each of these represents a way in which economic integration can encourage the niche specialisation that generates productivity gains. These gains represent the main advantages of deep integration and compensate for any losses to trade diversion from shallow integration.

Our analysis suggests that intra-industry trade in India started a good way behind China and Brazil in 1992, but had caught up with and indeed may have overtaken both of them by 2004. All three, however, lag well behind the US and above all the EU. The low level of the EU-India GLI confirms the story from the Herfindahl indices and RCA indicators of little direct overlap between Indian and EU trade patterns and competitiveness. On one hand this reinforces the inference that tariff cutting in an EU-India FTA could induce trade diversion losses for India given its high tariffs. The low level of the Grubel-Lloyd index of intra-industry trade, however, also underlines the potential for increased IIT, especially if TBTs and SPS barriers were reduced as part of the FTA.

On the question of horizontal versus vertical integration, it is noticeable that, the EU apart, vertical differentiation greatly exceeds horizontal. This is not surprising in the case of India, China and Brazil since they are likely to export e.g. low quality apparel and import high quality, or to be part of globally or regionally integrated supply chains. It is equally unsurprising that the EU is the exception where horizontal differentiation exceeds vertical, because it represents the most integrated market of national economies at broadly similar levels of development in a world where the cross hauling of differentiated but similar goods of equivalent qualities is likely. It is also worth noting that the share of horizontally differentiated trade grew faster than vertical in India between 1992 and 2004, perhaps representing improved quality of Indian goods.

EU trade with India is predominantly vertically differentiated and, while the share of horizontally differentiated trade has grown faster, it is still at a very low level. Once more this suggests that there is potential for preferential liberalisation towards the EU to generate productivity-increasing specialisation particularly on vertically differentiated trade.

## **2. Projected FDI and economic growth in India**

In this part of the report we consider in some detail the role of FDI in the context of a future FTA between the EU and India, and in the context of the growth of the Indian economy. The aim is to consider the role that FDI can play in stimulating trade, investment and economic growth, to evaluate the existing evidence with regard to patterns of FDI into India, and also to provide an empirical evaluation of the potential relationship between FTA formation and FDI flows. This part of the report is therefore divided into two key sections. The first section focuses on the qualitative discussion and statistics, and the second section details the quantitative work undertaken for this project.

### ***2.1. India: FDI flows - potential and actual***

FDI is typically viewed as being beneficial for the host economy because of the direct investment it brings but also because of the possible externalities which may be generated in the form of, for example, technology transfers and spillovers. This relationship between FDI and externalities is also closely related to the relationship between deep integration and externalities. Of course it is important to underline that in considering the relationship between FDI and growth, other features of the economy, such as trade policy, the legislative and regulatory framework, investments in education, and so on, all play an important role and should not be underestimated.

Since 1980, the Indian economy has grown by an annual average of 5.9%, which looks high compared to the world annual rate (3.36%) but is not as strong as the Chinese annual average rate of 9.8%. Over the last three years, however, the average growth rate of the Indian economy has improved, reaching 8.35%, even though economic performance varies remarkably between states and industrial sectors. GDP per capita has doubled in the last 10 years and as a consequence, the domestic consumer market has grown remarkably.

While world FDI inflows declined significantly after 2000 for China, Brazil, and India, there has been a reversal of that trend in more recent years. During the 1990s, engineering, services, electrical equipment and chemicals were the main target of international investments into India, whereas more recently, over the last five years, the transportation and telecommunications industries have ranked among the sectors attracting the highest FDI inflows, and engineering seems to have become more marginal. Nevertheless, it is also worth noting that only a small percentage of effectively approved FDI is subsequently realised. This appears to be true across all sectors, though to a lesser extent with regard to electrical equipment. In terms of source countries, between 1991

and 2005, Mauritius and the US were the main investor countries, whereas European countries held a very small percentage of cumulative FDI inflows.

According to the FDI confidence index (created by the Global Business Policy Council of A.T. Kearney, 2005), China and India are the first and second most attractive FDI locations in the world. In 2005, China held the position for the fourth year in a row and India rose from third to second, surpassing the US. Interestingly, India was only 15<sup>th</sup> in 2002. This suggests a very substantial rise in the attractiveness of India as a location for FDI flows in recent years. Despite this, there are some substantial differences between China and India (e.g. with regard to the perceived corruption index), which might explain the still wide gap in FDI inflows levels. In this part of the report, we also consider a range of indicators shedding light on the relative attractiveness of countries for FDI. What is striking when looking at many of these is how poorly India performs on these individual indicators (such the costs of starting a business, flexibility of labour laws, etc.). Given the evidence on the increases in FDI flows to India, this clearly suggests that the potential for increased investment flows to India is extremely high.

## **2.2. Modelling FDI flows**

In this section of the report, the objective is to formally assess the impact of the reduction/elimination of tariff and non-tariff barriers between RTA members, and the imposition of a common external tariff on intraregional bilateral FDI flows. We also try to investigate the underlying relationship between FDI flows and bilateral trade in two directions: imports from the source country to the host and exports from the host to the source country. Here, the aim is to evaluate the consistency of the “classical” theories on FDI and trade which consider them either complements or substitutes. In the first case vertical FDI seek to exploit international differential in price factors: the FDI is located in the unskilled labour-abundant host and serves the parent market via foreign affiliate exports (Helpman and Krugman, 1985). In the second case horizontal FDI are located abroad in order to save on trade costs by serving the overseas market locally (Markusen and Venables, 2000).

We carry out this analysis with a commonly used instrument for the empirical investigation of bilateral trade determinants, the *gravity model*. In its most elementary version, the equation posits that the volume of trade flows between two countries depends positively on their economic dimensions, measured by the level of their GDP and population, and negatively on the transport costs captured by the absolute distance between their biggest economic centres. Typically, then, additional variables (frequently dummy variables) are introduced with the aim to capture the effects of either geographical or institutional factors, which increase or shrink the distance between two countries. The result is an augmented gravity equation, which includes three types of determinants of bilateral trade flows: characteristics of supply in the exporter country, characteristics of demand in the importer country and elements which favour or obstruct the specific trade flows (common border, common language, past colonial links and geographical characteristics).

The most common way of including the effects of regional integration into the extended gravity equation is to include dummy variables for the RTAs in force during the sample period. Each dummy takes the value of one if the bilateral trade in the dependent variable is between two countries, which are in the same RTA, zero otherwise. For this study we wish to focus on the impact of North-South RTAs on FDI bilateral flows. We do this by distinguishing between four different types of RTAs: South-South; symmetric North-South; asymmetric North-South; and North-North. We are particularly interested in the coefficient on the symmetric North-South variable, as this corresponds most closely to the case of an EU-India FTA. However, the sign and size of the coefficient will inevitably be strongly determined by the countries which are included in the relevant bilateral pairings. In our sample, the North-South symmetric pairings are heavily dominated by the former Central and Eastern European Countries who were signing and implementing Association Agreements with the EU. In addition to these we have several other countries, including Turkey, Tunisia, Israel and South Africa. Clearly it is possible that FDI flows towards the CEECs may have also been influenced by other factors such as the likelihood of future accession to the EU. We have therefore divided the North-South symmetric dummy into two parts. This enables us to isolate the impact of trade agreements between EU/EFTA and Central and Eastern European (CEE) countries, as we expect FDI to these countries to have been affected more over time. We have also separately controlled for possible accession-style effects impacting on FDI flows with regard to the CEECs.

The coefficients for the RTA dummy variables can be interpreted as indicating the impact that the formation of a given type of RTA has had on bilateral FDI flows and stocks, while controlling for all the other factors included in the underlying regression equation. The percentage impacts, as derived by the estimations, are summarized in the table below.

**Table 2.1: Percentage increase in FDI flows arising from an RTA**

Coefficient for:	Based on two way investment “flows”		Based on “flows” from North to South	
	Flows	Stocks	Flows	Stocks
North–North RTA	NS	NS	NS	NS
Asymmetric North-South RTA	NS	+63%	NS	NS
Symmetric North-South RTA: CEEC	+32%	+44%	+28.9%	+84.5%
Symmetric North-South RTA: Other	+27%	+18%	+40.0%	NS
South-South RTA	-0.55%	-17%	NS	-82.0%

Considering these, we see that with regard to symmetric North-South RTAs, there is clear evidence that the formation of an RTA increases bilateral FDI between countries – be this measured via flows or via stocks. When considering both sets of flows, we see that the increase in FDI ranges from 27% (for “other”) to 32% (for the Central and Eastern European countries), and with regard to stocks, the increase ranges from 18% to 44% respectively. When considering only one-way flows from the OECD countries to the Southern partner countries, the increase in FDI for the CEECs is 28.9% with respect to FDI flows, and 84.5% with regard to stocks. For the remaining North-South RTA

countries, the increase in stocks was not significant, while the increase in FDI flows was of the order of 40%.

### **3. Trade policies in India regarding non-tariff barriers, services, and regulatory issues**

In this part of the report we summarise the cases we have examined with regard to non-tariff barriers, services and regulatory issues. In each section, we review the background, including WTO disciplines already in place and the scope for preferential arrangements, and we discuss bilateral issues that have arisen between the EU and India. Our main focus, however, is not to enumerate differences of position but rather to provide an analytical account of the rules and processes that give rise to Indian policy and practices in each area. The analysis in this part of the report is not as in-depth, and for details the reader is referred to annex 3. We conclude with a discussion of possible areas for negotiation. We also try to avoid speculating on the feasibility of these issues in this FTA as this aspect is covered in part 4 and annex 4 of the report.

We selected the areas of priority to explore on the basis of guidance from the Commission in order to clarify why barriers arose in various areas rather than determine what they were. The analysis is based on fieldwork in India, consisting of interviews with actors from the EU, Indian government officials and stakeholders, and analysis of documents available in India.

#### ***3.1. GOVERNMENT PROCUREMENT***

##### **3.1.1. Background and Issues**

Government procurement is an important issue for the EU and public purchase policies in India are often subject to non-transparency, lack of national treatment and the absence of a formal system for redressing grievances in the award of contracts. Unlike the EU, India is not a signatory to the WTO's Agreement on Government Procurement (GPA) and is thus not subject to the latter's disciplines.

The Indian system differs from the provisions of the WTO Agreement on Government Procurement (GPA) mainly with respect to national treatment, transparency, and challenge and review mechanisms. India's biggest problem with any government procurement agreement is with the "national treatment" requirement, which emanates from the preferences applicable in public procurement at various levels of government in line with the use of government procurement as an instrument for directing investment to desirable sectors. There are no price preferences in this procurement at the central government level, only purchase preferences accorded to both SMEs and PSEs. However, price preferences exist for state level procurement and for purchases made by Indian Railways. There are no provisions in India that require information on winning contracts to be made public and that each entity, on request, provides pertinent information concerning the reasons for rejection and the characteristics and relative advantages of the successful bidder. India also does not have a formal bid challenge procedure as there is

no independent adjudicating authority, and the concerned department generally deals with the disputes itself.

### **3.1.2. Data**

There is no documented evidence of foreign involvement in government procurement in India. Moreover, few estimates are available for the total value of government procurement in India, and those that do exist involve different methodologies and sets of data, which explains the discrepancies in them. According to Srivastava (2003), the total value of purchases by the central and state governments and public enterprises subject to international competitive bidding varied between 3.5 and 5.7% of GDP over the period 1998-2001.<sup>4</sup>

### **3.1.3. Procedures & Processes in India**

The general principles governing procurement by the government are laid down in the General Financial Rules (“GFR”) of the Ministry of Finance and the purchase procedures followed by various government departments have evolved in line with these general principles. In principle, the government procurement system in India is set up to ensure the purchase of good-quality products in the most economic and efficient manner. The Directorate General of Supplies and Disposal under the aegis of the Department of Supply is the central purchasing organization of the Government of India. Based on GFR 1961, rules governing state level procurement are broadly similar, with the notable exception of Bihar which, together with the central government, has revised its rules in line with GFR 2005. However, as with the case of investment in India, often there is wide variation in the standard of government procurement procedures. Some of the more advanced states like Karnataka and Tamil Nadu have introduced legislation on transparency, while others like Uttar Pradesh have procurement practices that reflect their generally lower quality of governance. State level procurement broadly differs from that at the Centre in terms of having much lower threshold limits for open tenders and in terms of the system of preferences. Price preferences still exist at the state level for industrial units (both small and large) and for products of the concerned state, while these have been done away with completely at the Centre, where only purchase preferences for small-scale units and village enterprises exist. Dispute settlement bodies are also different in the states even as the procedures are broadly similar. The chart on page 30 provides a broad overview of government procurement procedures in India.

### **3.1.4. Issues for Possible Negotiation**

Transparency in procurement with respect to tender documentation specifying criteria for awarding contracts, disallowing negotiations with the lowest bidder, requiring debriefing of the unsuccessful bidder and the publication of contract awards are the issues that could be negotiated in this FTA. Most importantly, clearly defined arbitration, formal appeal or bid challenge procedures are needed. The EU could also negotiate a centralized database

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<sup>4</sup> See Annex 3 for more details.

with information on government contracts in India, both at the level of the central government and for state-level purchases.

# GOVERNMENT PROCUREMENT

**CENTRAL  
GOVERNMENT +  
GOVT. OF BIHAR**

**OTHER STATE  
GOVERNMENTS**

**INDIAN RAILWAYS**

## TENDERING PROCEDURES

BIDS NOT INVITED FOR  
VALUE < Rs. 15,000. OPEN  
TENDER FOR VALUE > Rs.  
2,500,000. THREE WEEKS  
ALLOWED FOR RESPONSE.

LIMITED TENDERS FOR  
VALUE < Rs. 10,000; OPEN  
TENDERS ABOVE THIS.  
THREE WEEKS ALLOWED  
FOR RESPONSE.

OPEN TENDER FOR VALUE  
> Rs. 5 MN. GLOBAL BIDS  
THROUGH OPEN TENDERS  
ONLY.

## PREFERENTIAL TREATMENT

PURCHASE PREFERENCES  
FOR SSIs, PSEs & COTTAGE  
& VILLAGE INDUSTRIES

PRICE PREFERENCES FOR  
UNITS LOCATED IN STATE;  
15% FOR COTTAGE & SSIs,  
3% FOR MEDIUM & LSIs

PURCHASE PREFERENCES  
TO PSEs BETWEEN Rs. 50  
MN & 1 BN. 15% PRICE  
PREFERENCE FOR SMEs.

## DISPUTE SETTLEMENT

STANDING REVIEW  
COMMITTEE UNDER  
DGS&D

APPEAL MADE TO SECRETARY  
(INDUSTRY). DISPUTES REFERRED TO  
OFFICER APPOINTED BY STATE GOVT.

## **3.2. SERVICES (including investment issues)**

### **3.2.1. Background and Issues**

The services sector is extremely important for the two trading partners and from the perspective of this FTA, a substantial coverage of services a la GATS Article V could help deliver improved access to mutual markets and more rapid liberalization of India's services than can be accomplished unilaterally. The challenge for the FTA is not only to accelerate liberalization in India's services sectors (which is continuing, albeit slowly at times and at a varied pace across sub-sectors), but also to facilitate the implementation of a range of complementary reforms designed to improve the quality of regulation.

Our comprehensive database on non-tariff barriers indicates that EU has had specific market access/national treatment issues and regulatory impediments with India in the case of satellite services (lack of national treatment), telecom (lack of national treatment and burdensome domestic regulation), private security agencies (limits on FDI), courier (proposed legislation on taxation) and air transport services (tax on business/first class tickets for passengers embarking in India). In general, India's services suffer from a range of horizontal barriers such as archaic laws, multiplicity of rules and regulations, inconsistent practices across states and multiplicity of contact points at different levels of bureaucracy, regulatory gaps, public sector bias and limits on foreign investment and ownership. Based on these, and from the perspective of European interests, services sub-sectors can be classified as open (IT, telecom); moderately liberalized (construction, health, banking and insurance, education, courier); and closed (legal, accountancy, postal, distribution). The full report analyses the regulatory regimes in some detail. On the whole, the EU might expect commitments from India in courier (especially express delivery), distribution, environment, life insurance, news agency and maritime services. On the other side, India's interests lie increasingly in mode 1 and not merely mode 4.

### **3.2.2. Data**

In Annex 3 we provide a new set of calculations for a rough quantification of India's commitments under GATS, and a comparison thereof with India's Revised Offers in each sector across the three modes of service delivery as well as the autonomous liberalization undertaken by India in Mode 3. As the annex indicates, the level of actual market access granted in services is very low in India's GATS commitments, averaging around 10% on the index we use<sup>5</sup> across the first three modes of service delivery; moreover, very few sectors have actually been scheduled under GATS. India submitted its much improved Revised Conditional Offer under GATS on August 12, 2005, wherein extensive proposed commitments have been made in a number of new sectors/sub-sectors of the Central Product Classification. New commitments have also been offered in Mode 1 and further improvements made in the sectoral coverage in Mode 4 such that the average level of actual market access granted has increased to 40.3%. However, even if the Revised Offers were incorporated into an EU-India FTA, it would be hard to argue that this would

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<sup>5</sup> For details of the method used see Annex 3.

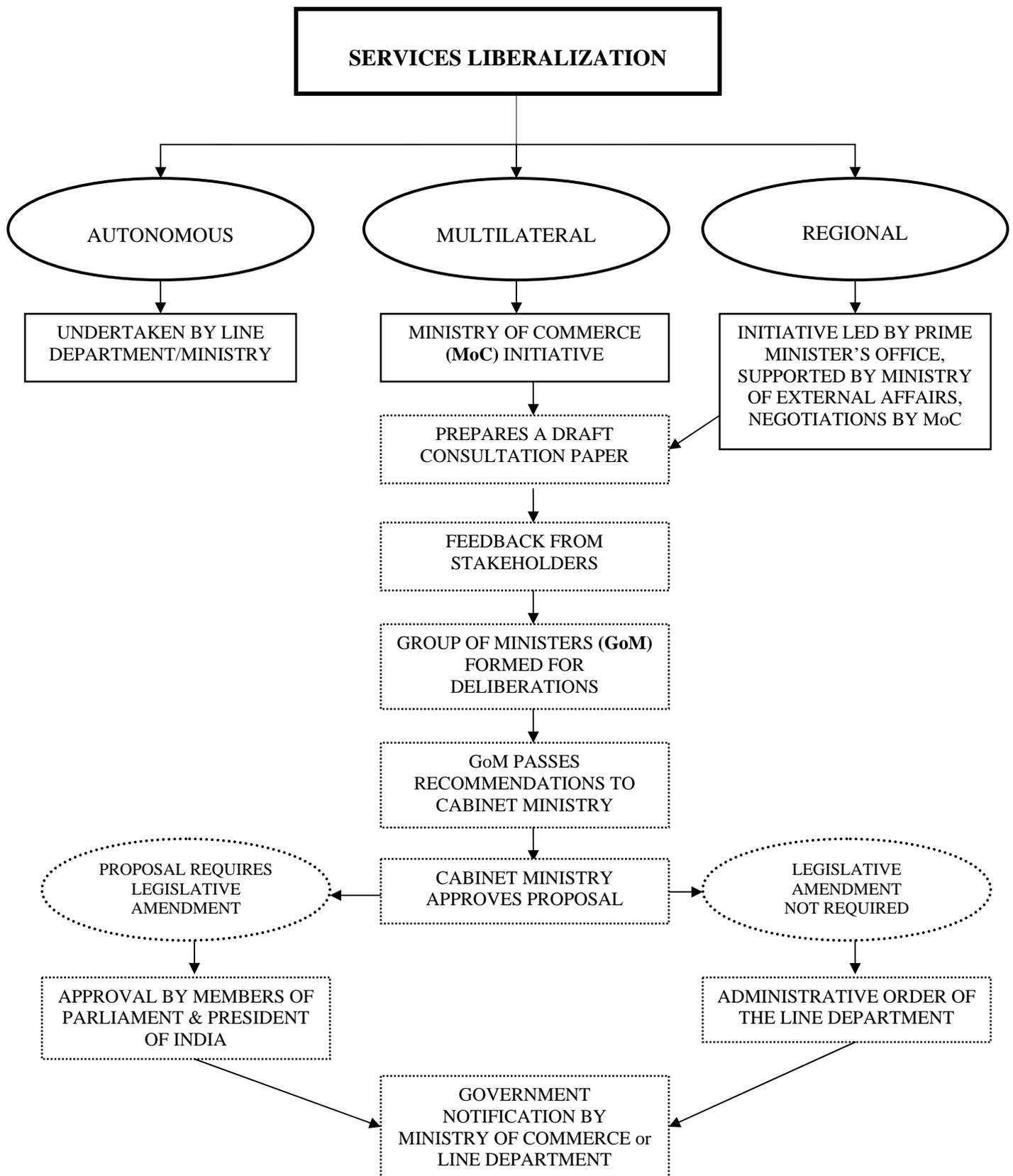
meet the requirements of Article V of the GATS. On the other hand, India seems to have done a lot better autonomously, with the average level of market access granted across sectors being close to 70%. Full details of India's autonomous policy in various services sectors and the agenda for moving ahead in this FTA are indicated in the annex.

### **3.2.3. Procedures & Processes in India**

Autonomous liberalization measures in services are initiated at the level of the line departments and ministries. Those for multilateral trade negotiations are initiated by the Ministry of Commerce, while those for RTAs are a Prime Minister's Office-led initiative, supported by the Ministry of External Affairs, with the negotiations done by the Ministry of Commerce. The entire process of the government's policy-making on services is illustrated in the chart on page 33.

### **3.2.4. Issues for Possible Negotiation**

From the European perspective, an important possible objective from an EU-India FTA would be to consolidate the extent of market access in IT and telecom services; to significantly improve market access in the moderately liberalized services; and to open up the sectors that are completely closed at present. The sectors where the EU appears to have a key strategic interest in the Indian market include financial, retail, accountancy, legal, telecom and maritime services.



### **3.3. INVESTMENT ISSUES OTHER THAN SERVICES**

#### **3.3.1. Background and Issues**

The various issues in investment are foreign direct investment (FDI) caps (though mostly in services), barriers to effective implementation including transparency and state level differences and other horizontal regulatory issues affecting investment climate.

#### **3.3.2. Data**

Since 1991, India has been substantially liberalising and simplifying its FDI regime to attract higher foreign investment, which has led to an increase in FDI inflows. FDI into India is increasing but not as fast as into China. As per the Reserve Bank of India's (RBI) revised calculations using international norms (including reinvested earnings etc.<sup>6</sup>), provisionally India received FDI of US\$ 7,751 million in 2005-06, which is 37% higher than the previous estimate of US\$ 5,546 million. Moreover the gap between approved investment and actual investment is quite substantial. Less than 50% of foreign direct investment (FDI) projects which are approved by the Indian government actually materialise. Further, outward investment is rising very fast; it exceeded inward investment in 2005. Lastly, there is a high regional concentration. Nearly half of inward FDI is divided roughly equally between two big regions: Delhi, Part of UP and Haryana and Maharashtra, Dadra & Nagar Haveli, Daman & Diu.

In the India-Singapore Comprehensive Economic Cooperation Agreement (CECA), MRAs on conformity and standards were signed for four products: food, drugs, telecom and electric goods. It also contains a section on technical training. India has MRAs with five other countries.

#### **3.3.3. Procedures & Processes in India**

India has liberalised its FDI regime in recent years and therefore FDI in the manufacturing sector is largely open to foreign investors. A few of the policy-related barriers are small scale industries (SSI) reservation, special economic zones policy, and taxation structure, which is non transparent and burdensome.

However procedures are a greater problem. There is a multiplicity of procedures and too many agencies dealing with clearances, especially at state levels. First, a foreign investor has to seek approval and clearances at the central level. A foreign investor can enter through the FIPB route or the RBI route. Once investors receive central approvals, they need to approach state governments for allotment of land/shed, acquisition of land, change in land use, approval of building plan, release of water connection, etc. While FDI rules in the states are the same, there are differences in practices, efficiency level, bureaucracy and political factors across states. Typically approvals in most states take about 2 months; however, in some states approvals can take up to 7-12 months. Some state governments, however, have set up investment facilitation centres and e-governance. Environmental clearance probably takes the maximum time, and for certain

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<sup>6</sup> See the RBI website for more details

types of investment projects e.g. power, a greater number of approvals is required. There is no 'single window' from which investors can get all the information about different states.

Investor experiences in operating of some states are better than in other states. Southern states, Andhra Pradesh, Karnataka and Tamil Nadu seem to have fared better than others in attracting certain kind of investment e.g. in automotive sectors, information technology etc. Some factors that determine investment attractiveness of states are:

- federal policies
- natural advantages of a state
- infrastructure
- education and skills
- law & order
- quickness of decision making
- labour relations
- land
- attitudes

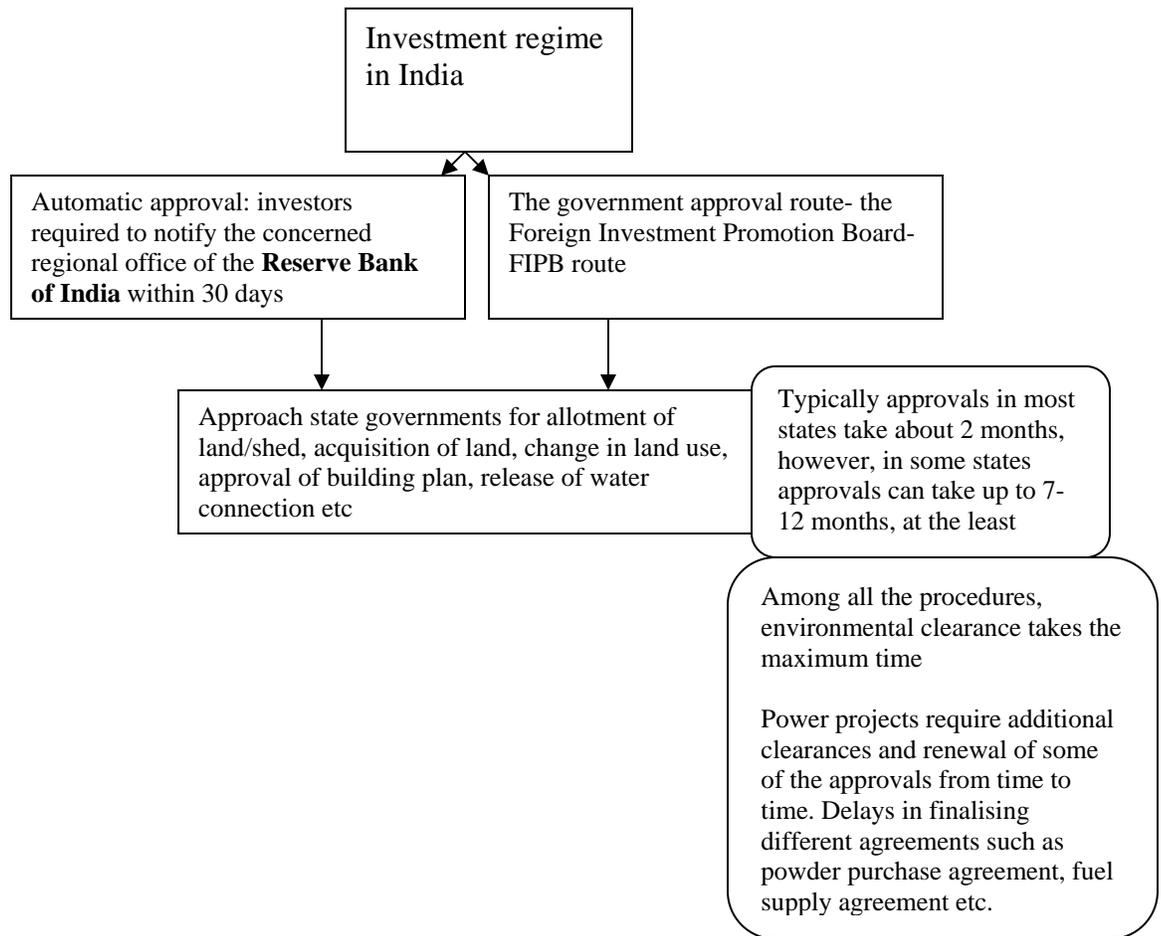
Indian states also give a number of incentives such as tax concessions, concessions on land and infrastructure costs, environmental standards and in some cases exemptions from labour laws. There is a strong competition among the states for investment. Often so many incentives at so many levels create confusion among potential investors.

An important dimension in EU-India investment relations concerns perceptions of each other's market, where there is perhaps a lack of cross-market or mutual awareness.

India has signed BIPAs with 18 EU Member States (See Table 3.5 in Annex 3). The agreements typically contain clauses on investment promotion and protection, national treatment and most favoured nation treatment, expropriation, compensation for losses, repatriation of investment, dispute settlement between companies and the state, and between states.

#### **3.3.4. Issues for possible negotiation**

The investment agreement could provide for transparency and setting up a system of a single window information system for investors of both the economies. Certain problems cannot perhaps be dealt with in an FTA, e.g. issues related ownership of land and labour policy in India. Such issues are state subjects and politically controversial. However, issues such as Press Note 1 of 2005, SSI reservation policies and positive list for India can be dealt with in the investment chapter.



### **3.4. TRADE FACILITATION**

#### **3.4.1. Background and Issues**

Trade facilitation is also an important issue from the perspective of this FTA. While trading conditions in India have improved, the key issues of concern in trade facilitation in India are transparency, different implementation/enforcement policies, complex procedures for calculating customs duties, delays in customs clearance and inter-state variations in internal transit procedures.

#### **3.4.2. Data**

Such barriers have translated into inefficient time delays and cost over-runs and India fares much worse than the OECD and China on most World Bank indicators of cross-border trade. India fares much worse than the OECD and China on all these indicators and in terms of trade documentation required, has a more onerous regime than the one on average for the entire South Asian Region (“SAR”).

**Table 3.1 Snapshot of customs procedures**

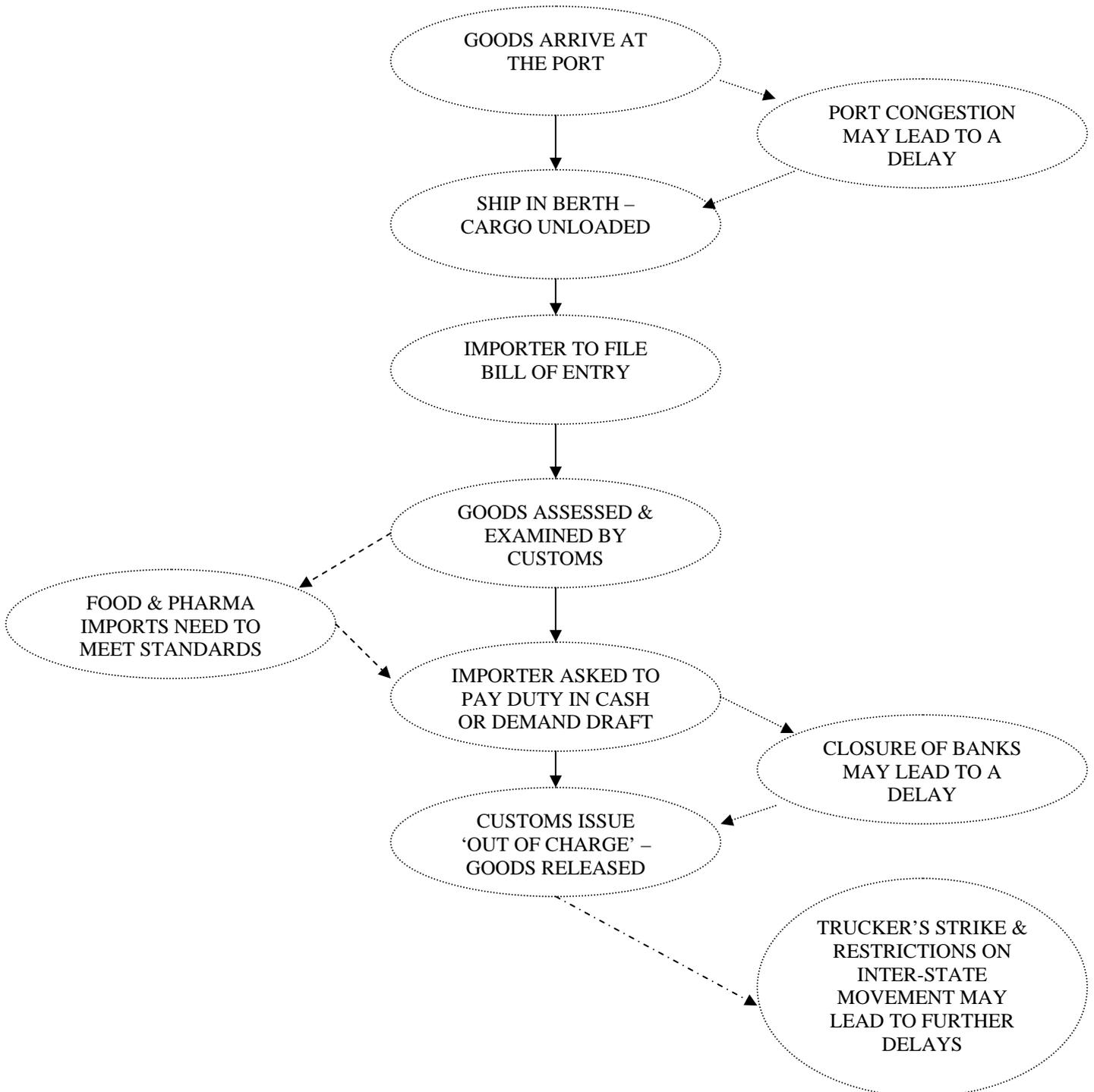
Trading across borders...	India	SAR	OECD	China
Documents for export (number)	10	8.1	4.8	6
Time for export (days)	27	34.4	10.5	18
Cost to export (US\$ per container)	864	1,236	811	335
Documents for import (number)	15	12.5	5.9	12
Time for import (days)	41	41.5	12.2	22
Cost to import (US\$ per container)	1,244	1,495	883	375

Source: Doing Business Report, World Bank (2006)

#### **3.4.3. Procedures & Processes in India**

Once goods have landed at the port/airport, officials of the Indian Customs & Central Excise Service are primarily responsible for clearing the goods. Other agencies that come into play are the Airport Authority of India or the Port Operator as applicable, banks, Customs House Agents and Food Control Laboratories (in the case of food imports). The chart on page 37 illustrates the exact process of customs clearance in India as per discussions with senior officers in the Indian Customs & Central Excise Service.

## CUSTOMS CLEARANCE PROCEDURES



#### **3.4.4. Issues for Possible Negotiation**

The ambit of trade facilitation is broad and the facets that could become the subject of this FTA include port logistics, the application of modern customs procedures, facilitating inter-state commerce, harmonising of standards, improving trade information and e-business facilities, and fostering administrative transparency and professionalism.

### **3.5. TRADE DEFENCE**

#### **3.5.1. Background and Issues**

Trade defence measures include anti-dumping and countervailing duties and safeguards that may be imposed on imports. While anti-dumping duties are imposed to offset the effects of injurious dumping in the importing country markets, CVDs are imposed to offset the injurious effects of a countervailable subsidy that the exporter gets from the exporting country government. Indian rules incorporate a mandatory less-duty rule. There is no mandatory public interest test but the Ministry of Finance has declined to impose duties in some cases. The chart on page 41 provides a broad overview of trade defence measures in India and of the relevant authorities responsible for their investigation and implementation.<sup>7</sup>

While India is acquiring the dubious distinction of being the largest user of anti-dumping duties, most of these are against imports from South-east and East Asia in general and China in particular. However the EU is the number two target of India's imposed measures and India is the second largest user against the EU. There have been consultations at the WTO between India and the EU. Above all the EU has recently raised issues about the quality of Indian AD procedures and succeeded in securing the withdrawal of a large number of Indian cases. The EC, however, continues to regret "the weak injury and causality analysis, disrespect of the confidentiality rules leading to partly meaningless disclosures, and disregard of comments submitted by the EC exporters<sup>8</sup>."

#### **3.5.2. Data**

In the period 1993-2005, India became one of the world's leading users of anti dumping, with duties imposed rising from six in 1993-1995 to 165 in 2001-2003, though the figures have since fallen. Despite the recent decline in the number of cases brought against the EU, the number of measures in force remains a concern. In 2005, 21 of the 103 AD measures in place against the EU came from India, down from 29 in 2003 and 34 in 2004. The major product categories attracting anti-dumping duty from the EU are Chemicals & Petrochemicals, Pharmaceuticals, Fibres/Yarns, Steel and other Metals and Consumer Goods. EU trade affected by Indian definitive measures -

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<sup>7</sup> For a full discussion of India's anti dumping regime see Kommerskollegium/National Board of Trade, Sweden: Report (2005-02-10) *The Use of Antidumping in Brazil, China, India and South Africa*,

<sup>8</sup> 'Overview of the Third Country Trade Defence actions against the Community,' Annual Report, DG Trade B.2, November 2006, p. 16.

calculated at the time of imposition of measures -amounted to ca. €46 million by the end of 2006<sup>9</sup>. Further details are in the annex. India has not used CVDs to date.

### **3.5.3. Procedures & Processes in India**

Trade defence measures in India fall under the jurisdiction of the Directorate General of Antidumping and Allied Duties in the Ministry of Commerce. The Designated Authority initiates and carries out both the dumping and the injury investigations, and makes a ruling based on its findings, the entire process taking between 12 to 18 months. Information on these investigations is made public through The Gazette of India, Extraordinary (an issue of the Ministry of Commerce), and online. The implementation is then carried out by the Ministry of Finance. Safeguards, on the contrary, are imposed with the sole objective of protecting domestic industry and the entire process of investigation, rulings and implementation for this, which may take up to 8 months, is carried out by the Ministry of Finance. India does not use CVDs.

Despite the fact that a recent study for the Swedish government concluded that Indian legislation is WTO consistent, as noted above, the recent EU complaint at the WTO against Indian AD measures highlighted a number of defects of process, some of which may still be problematic despite the withdrawal of the specific contested measures.

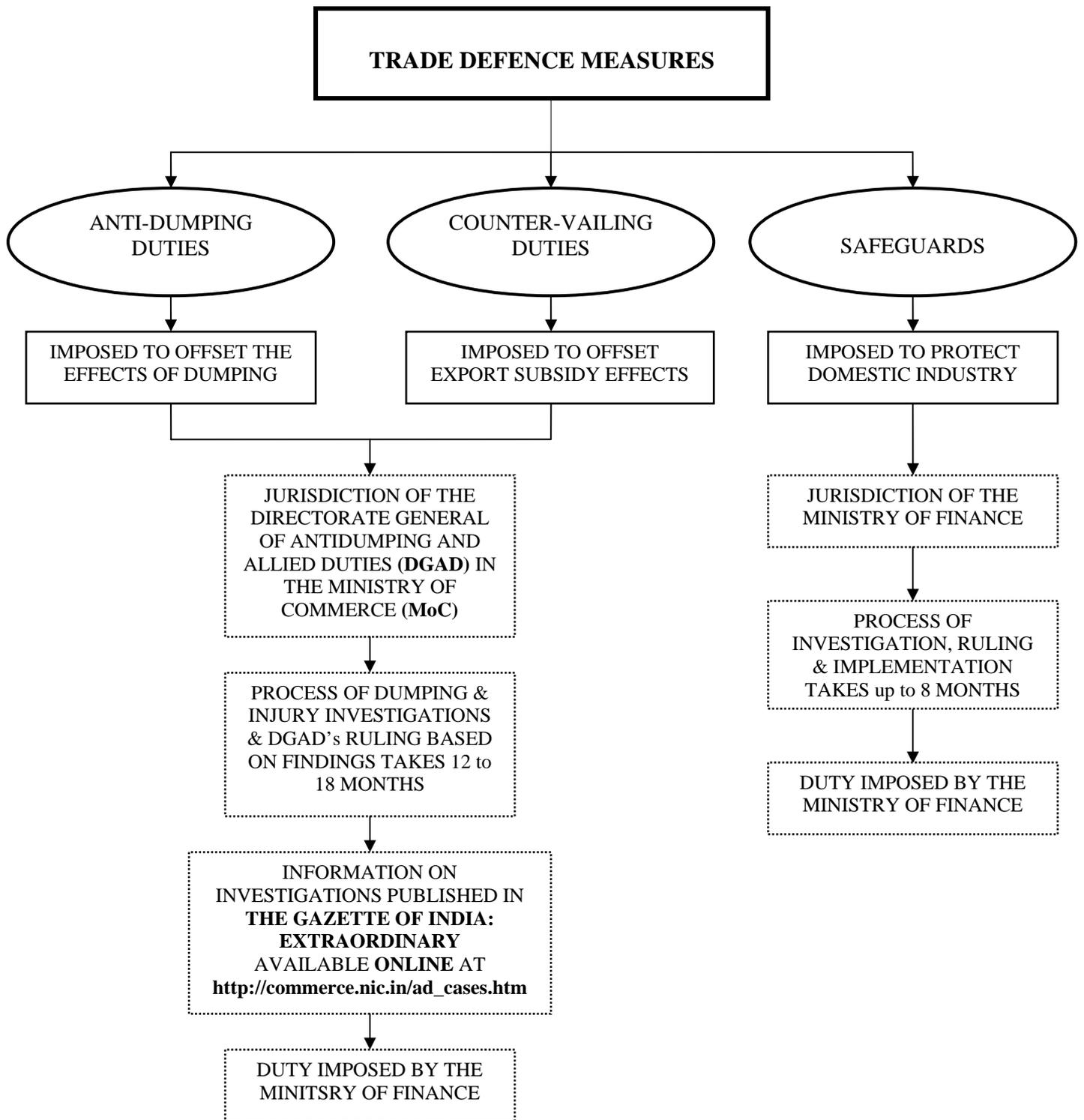
### **3.5.4. Issues for Possible Negotiation**

Neither the EU nor India has historically dealt with AD in FTAs (other than with between the EU and its immediate European partners). The signing of an FTA might be the occasion for India to consider reforming its procedures in a WTO-compatible way, for example, including a mandatory public interest test and tightening its lesser duty rule.<sup>10</sup>

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<sup>9</sup> Source: communication from Commission

<sup>10</sup> Kommerskollegium/National Board of Trade, Sweden: Report (2005-02-10) *The Use of Antidumping in Brazil, China, India and South Africa*, p. 43 states that India does operate a mandatory lesser duty rule, but research for part 4 suggested some possible ambiguity in this. India, however, has tabled proposals at the WTO for a mandatory lesser duty rule for all Members.



## **3.6. SPS AND TBT ISSUES**

### **3.6.1. Background and Issues**

There are several sectoral issues in Sanitary and Phyto-Sanitary Measures (SPS) and Technical Barriers to Trade (TBT) related to India but there is a general perception by the EU that the Indian approach lacks transparency, standards issues (especially SPS) become politicised, and decisions are not always taken on the basis of clear scientific evidence. Furthermore, there have been allegations even from within India that the Indian government has been using standards as non-tariff barriers especially after the abolition of quantitative restrictions in 2001. There are also horizontal factors such as the bureaucracy, corruption and the slow process of decision making that affect the standards regime in India. The BIS functioning often appears to be slow and bureaucratic. Some of the sector-specific problems are in auto, bottled/mineral water, primary products, import of plants and animal products etc. There are problems related to mandatory certification and maximum retail pricing.

### **3.6.2. Data**

The BIS has formulated standards for 14 broad sectors, nearly 19,000 standards and employs around 20,000 technical people; around 6000-7000 are product specific standards. Estimates of the number of Indian standards which are harmonised with international ones range from 3,000-5,000, and there are a few others based on international standards, but with variations to account for Indian climatic or economic conditions<sup>11</sup>. Not all standards are operated by the BIS. For instance, AGMARK (operated by the Ministry of Agriculture) is for raw agricultural goods, dealing with 181 products. There are also 500 labs in India, of which only eight are BIS labs. There are 3 SPS enquiry points and 1 TBT enquiry point.

Standards for few products are relatively developed such as electrical/electronic goods and medical devices, while India does not have any standard for toys. Standards for drugs are not well developed in India either. The Central Drugs Standard Control Organisation of India reportedly does not have the capability to certify on standards comparable to the ones imposed by the US Food and Drug Authority (FDA)<sup>12</sup>. In electrical appliance and packaged drinking water, Indian standards are largely similar to international standards. Standards for medical laboratories (labs) are also developed. There are a few ISO 15189 medical labs. On food, concepts on standards are not as well developed but still food labs are first accredited and then accepted<sup>13</sup>. Some major products still do not have well developed standards. Unlike many other countries, there is no mandatory certification on monitors, computer peripherals etc. in India. Newer standards are nevertheless being developed. For example, in June 2006 the BIS came out with specific international safety standards for information security management systems (ISMS) for the IT industry. These standards are identical to the standards issued by the International Standardisation Organisation (ISO) and International Electrotechnical Commission (IEC)<sup>14</sup>. There are about 50

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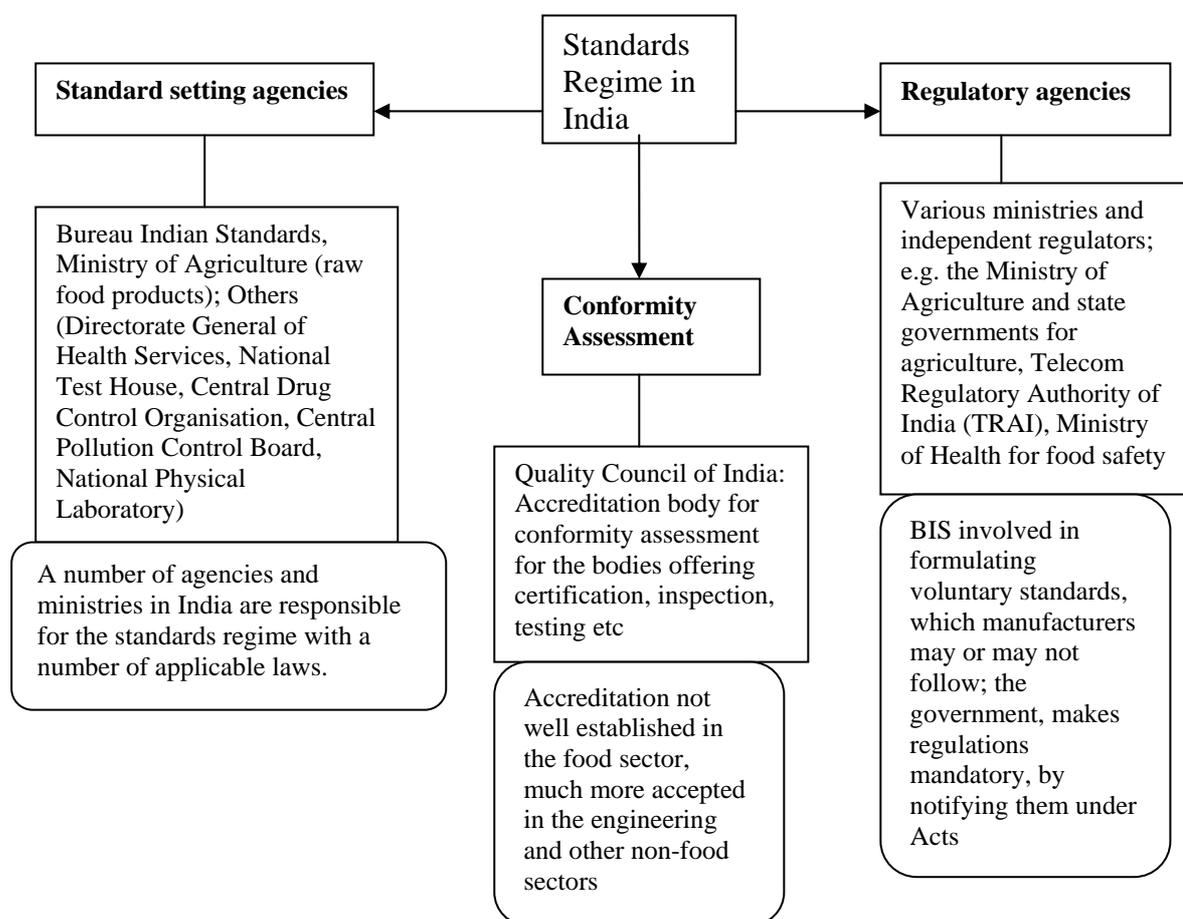
<sup>11</sup> Based on information provided by the BIS.

<sup>12</sup> Source: interview

<sup>13</sup> Source: interview

<sup>14</sup> [www.tribuneindia.com/2006/20060605/biz.htm](http://www.tribuneindia.com/2006/20060605/biz.htm) - 54k

bodies in India providing ISO certification<sup>15</sup>. India is also slowly learning and accepting the system of accreditation.



### 3.6.3. Procedures & Processes in India

There are different regimes for trade and domestic production for domestic market because often exporters must meet higher standards internationally in the US and EU markets. However there is a lack of clear information such as a single enquiry point where all the information regarding various standards regime could be available. This problem is more acute for importers, i.e. foreign exporters. There are doubts about technical capacity and independence of BIS from business interests.

The multiplicity of standards-setting bodies creates confusion. For example, though the CODEX contact point in India is the DGHS in the Ministry of Health, the Ministry of Food Processing Industries is closely associated with the activities of *Codex Alimentarius* as well.

<sup>15</sup> Source: interview

Though the BIS is the key player, other important agencies are Agricultural Marketing Information System Network (AGMARKNET) in the Ministry of Agriculture, Directorate General of Health Services (DGHS) in the Ministry of Health and Family Welfare, Central Pollution Control Board in the Ministry of Environment & Forests, National Test House in the Ministry of Consumer Affairs, and the Central Drug Standard Control Organisation in the DGHS. The food and drug standards regimes are separate. The DGHS main regulatory body for food standards under the Prevention of Food Adulteration Act (PFA) 1954 and the Central Drug Control Organisation is the regulatory and standards authority for drugs. The BIS has mandatory certification for certain food items and edibles e.g. baby food. The Food Safety and Standards Act 2006 established a Food Standards Authority and will be based on Codex principles and eliminate the multiplicity of laws and agencies by bringing them under one umbrella. However it perhaps poses a huge problem of implementation.

**Table 3.2: Important Ministries and Laws on Standards and Quality in India**

Ministries	A Few Laws Governing Standards
Ministry of Agriculture: <i>Various departments</i>	Agricultural Produce (Grading and Marking) Act, 1937 (AGMARK) Insecticides Act 1968 Milk and Milk Product Control Order (MMPO) 1992 Meat Food Product Order 1973 Plant Quarantine (Regulation of Import into India) Order, 2003. Livestock Importation Act
Directorate General of Health Services, Ministry of Health and Family Welfare	Prevention of Food Adulteration Act 1954
Ministry of Food Processing Industries	Fruits & Vegetable Products (Control) Order – FPO 1955 Food Safety and Standards Act, 2006
Department of Commerce, Ministry of Commerce	Export (Quality Control & Inspections) Act 1963
Ministry of Consumer Affairs, Food and Public Distribution	Standards of Weights & Measures Act, 1976 Bureau of Indian Standards (BIS) Act 1986 Essential Commodities Act, 1955. <i>Various orders passed under the Essential Commodities Act</i>
Central Pollution Control Board, Ministry of Environment & Forests	Water (Prevention and Control of Pollution) Act, 1974 Air (Prevention and Control of Pollution) Act, 1981 Environmental (Protection) Act, 1986
Bureau of Energy Efficiency Ministry of Power	Energy Conservation Act 2001
Chief Controller of Explosives, Department of Industrial Policy & Promotion, Ministry of Commerce	Indian Explosives Act, 1884 Petroleum Act, 1934 Inflammable Substances Act, 1952
Directorate General of Mines Safety, Ministry of Labour & Employment	Mines Act 1952
Department of Road Transport and Highways, Ministry of Shipping, Road Transport and Highways	Motor Vehicles Act 1988

*Source: Websites of Various Ministries of the Government of India*

India's official export certification body is a part of the Ministry of Commerce & Industry (MOCI); its certification is recognised by the European Commission for Basmati rice (certificate of authenticity) and fish & fisheries products; other agencies are Agricultural and Process Food Products Export Development Authority (APEDA) and Marine Products Export Development Authority (MPEDA). The EC has agreements with both the agencies to approve imports from their certified laboratories and establishments.

India cannot apply higher standards to imports than that for domestic production (violation of the National Treatment principle). Compared to India's domestic and exports standard regime, its imports regime has received less attention from the government and others. The import regime in India is governed by the following agencies<sup>16</sup>:

- Directorate General of Foreign Trade (DGFT) in the MOCI
- Relevant Regulatory Authorities
- The BIS

Importers are required to obtain a number from the DGFT for importation of goods. Foreign manufacturers and Indian importers can seek certification from the BIS for marking their product with the Standard Mark. The BIS launched its Product Certification Scheme for foreign manufacturers and Indian importers in 1999. Importers also have to approach the relevant regulatory authorities,<sup>17</sup> such as in the following cases:

- Food ingredients and additives with genetically modified or bioengineered organisms authorised by the Genetic Engineering Approval Committee, Department of Biotechnology, Ministry of Science and Technology. The authorisation is valid for four years.
- Meat and poultry product imports are subject to compliance with all the provisions of Meat Food Product Order.
- An approval from the Ministry of Agriculture is required for import of primary agricultural products.
- Import permit issued by the Ministry of Agriculture is required for list of plants, plant products and seeds, and is valid for six months under the Quarantine Order, 2004.
- Regulation on gas cylinders is handled by Petroleum and Explosives Safety Organisation (PESO) MOCI, which is responsible for the administration of Explosives Act, 1884, Petroleum Act, 1934 and Inflammable Substances Act, 1952.

There are some sector specific problems such as:

- Automotive sector: The Government of India set up an Automotive Industry Standards (AIS) Committee, which formulates standards that are converted into Indian standards by the BIS<sup>18</sup>. The industry has been suggesting that a

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<sup>16</sup> Department of Commerce, MOCI

<sup>17</sup> [http://r0.unctad.org/trains\\_new/country\\_notes/india\\_2005.PDF](http://r0.unctad.org/trains_new/country_notes/india_2005.PDF)

<sup>18</sup> [www.competition-commission-india.nic.in/competition\\_forum/iti\\_comp\\_comm\\_pres.pdf](http://www.competition-commission-india.nic.in/competition_forum/iti_comp_comm_pres.pdf)

national standard regime for the sector be created by merging BIS with AIS standards. Since 2000, United Nations Economic Commission for Europe (UNECE) regulations have been used as a basis for Indian regulations and since 2003, India has made efforts to technically align national standards (AIS/BIS) with ECE, though with a few variations<sup>19</sup>. The issues faced by the tyre industry are a good example of the challenges faced by the automotive sector in India. Large tyre companies in India have all voluntarily adopted BIS standards so apparently there is no violation of the national treatment clause. However, there are speculations about whether the new regulations on tyres could be looked at as means to protect the domestic industry. Given the complexity and dynamics of the industry, and the slow decision making process, it is unlikely that issue of tyres and homologation of cars<sup>20</sup> would be solved by the AIS or BIS soon.

- **Mineral/bottled water:** The regulations on mineral and bottled water came into force as a result of a big debate in the Indian media in 2003 on the presence of pesticides in mineral and bottled water sold in India. The Department of Consumer Affairs immediately assembled a committee to look into the issues. A comparison of BIS standards with international standards revealed that the BIS norm on pesticides was actually more stringent than international requirements but there were lapses in procedures and testing<sup>21</sup>. While measures to bring Indian standards in line with international standards were being adopted, the BIS expressed its inability to align completely with international standards. For mineral water, only producers based in certain geographical areas of India are able to meet the high standards<sup>22</sup>. Further, this is a politically sensitive issue in India and thus the BIS may be unable to relax its norms.
- **BIS Mandatory Certification:** The DGFT issued a notification in 2000 which said that products under the mandatory BIS Certification cannot be imported into India without BIS Certification. For compliance with this requirement, all foreign manufacturers of these products who intend to export to India are required to obtain a BIS product certification license. This is perhaps unusual because not many countries recommend certification to ensure compliance to standards. Information on the need to have mandatory certification on these particular commodities is not readily available. One of the reasons for having a mandatory certification appears to be quality upgradation in these domestic industries to protect health and safety of the population, especially since many of these products are domestically produced by tiny and small manufacturers. The BIS reviews its list from time to time. According to officials, 50 of these products will be taken off the list soon.
- **Maximum Retail Price:** In 1990, changes were brought into the Standards of Weights and Measures Act so that all manufacturers had to print maximum retail prices inclusive of all taxes. Till December 1990, manufacturers of

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<sup>19</sup> The Union Cabinet in October 2002, approved a proposal to join the World Forum for Harmonisation of Vehicle Regulations (WP.29) as an Observer and the constitution of a National Level Standing Committee to deal with issues pertaining to WP.29; <http://www.siamindia.com/scripts/harmonisation%20.aspx>

<sup>20</sup> There is mandatory homologation requirement of cars of value of less than US\$ 40,000, which again raises the question whether this is a protectionist measure.

<sup>21</sup> BIS

<sup>22</sup> Source: interview

packaged commodities in India could print the price of the commodity in two separate ways, one was 'retail price with local taxes extra', and the second one was 'maximum retail price inclusive of all taxes'. There were complaints from consumers and consumer organisations that retailers were over-charging consumers by adding on a cost to the printed price, under the guise of local taxes, even when the local tax was much lower. It was difficult for consumers to keep track of all local taxes on all products in a market<sup>23</sup>. However the new system came with downsides for domestic consumers – an issue which is still being debated in India. There is no indication that this regulation is likely to change soon.

- Bovine Products, Breeding Horses & Avian Flu: Imports of such products are regulated by Department of Animal Husbandry, Dairying and Fisheries, Ministry of Agriculture. However it is quite difficult to get information on how these standards and regulations have been decided. Officials from the Ministry of Agriculture are not easily approachable. It appears that the government has a risk assessment procedure to arrive at policy decisions, but the decision making in this area is not very transparent and the information is not readily available. Some of the protocols are outdated and often it takes time to make a decision because the government machinery moves slowly and more manpower and technical knowledge are likely needed.

There is a continuous process to revise various bans and restrictions on animals, plants, and animal products. For example, one of the contentious Indian regulations is the ban on meat to deal with Avian Flu. The Department of Animal Husbandry banned the import of specified livestock and livestock products in February 2006 following the outbreak of avian flu, under Livestock Importation Act, 1898. This was extended by six months in August 2006. The government changed its original notification to permit imports from Avian Flu negative countries. A country must receive a certificate from OIE. This policy is reviewed every three months and if a country attains a certificate from OIE, the restrictions on imports are lifted. Meanwhile the EU has expressed its concern that only two EU Member States were affected by the disease, while India prohibited imports from all EU countries. India has agreed to get back with a list of countries from which imports are permitted.

Another example is the issue of import of horses from CEM affected countries. The Department of Animal Husbandry in a recent clarification reiterated that certain categories of horses are allowed from EU countries which have not been affected by CEM. In the same clarification, the department pointed out that the relevant EU directives do not permit transit or trans shipment of Indian horses through the EU<sup>24</sup>.

- Food sector: Mainly because of consumer activism, but also due to proactive environmental and food authorities, a number of food safety measures have been adopted. The Government of India has set up a National Codex Committee under the Department of Health, Ministry of Health and Family Welfare.

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<sup>23</sup> Financial Express, 15 April 1999

<sup>24</sup> Letter from the Department of Animal Husbandry to European Commission Members dated 17 November 2006

In August 2006, the Government of India enacted the Food Safety and Standards Act with the aim to consolidate various laws governing food and to establish the Food Safety and Standards Authority (FSSA) of India to lay down 'science based standards of items of food and to regulate their manufacture, storage, distribution, sale and import', and 'to ensure availability of safe and wholesome food for human consumption'.

The Act consolidates eight laws, e.g. the Prevention of Food Adulteration Act, and various orders passed under the Essential Commodities Act. It envisages setting up a three tier structure: an apex FSSA, a Central Advisory Committee and various scientific panels and committees. The law is based on CODEX. The Food Authority will have representation from seven ministries: agriculture, commerce, consumer affairs, food processing, health, legislative affairs and small scale industries. The standards formed by the FSSA will include specifications for ingredients, contaminants, pesticide residue, biological hazards and labels. The law will be enforced through State Commissioners of Food Safety and local level officials. The FSSA is expected to start functioning in another six months.

While the new law eliminates the multiplicity of laws and agencies and brings them under one umbrella, it poses a potentially enormous problem of implementation. The involvement of local authorities offers scope for harassment and corruption. Nevertheless, the new law is expected to improve the food standards management in India.

It is difficult to assess whether access to the latest technologies or availability of skilled and trained manpower is a constraint for the BIS or any other standards or certification organisations in India. No definite estimate is available. While some government officials are confident that this is not a constraint for them, there are others who point out that, compared to developed countries, India does not have enough technical manpower<sup>25</sup>.

#### **3.6.4. Issues for possible negotiation**

There should be differences in ways of dealing with sectoral and horizontal issues while at the same time promoting overall transparency in the process of standards setting, and the scientific basis therein. There should also be transparency / clarity over the existence of standards and the lack of e.g. a single enquiry point. Both sides recognise the potential gains from forms of mutual recognition but this can be interpreted differently, and may be hard to achieve. The Indian side would ideally like to have mutual recognition of standards and technical regulations, whereas the EU is very sceptical. There may be more scope however, for moving forward on mutual recognition of conformity of assessment procedures, though even this is seen as problematic from the EU's point of view. There may be various ways to establish conformity assessment. Firstly, the two administrations could assess existing labs, certification and inspection bodies in each other's countries. Reportedly, such a process has already been initiated by the EC in India. Secondly, there could be accreditation of relevant bodies – a more cost effective procedure.

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<sup>25</sup> Source: interviews

## **3.7. Intellectual Property Rights**

### **3.7.1. Background and Issues**

This has been an area of major controversy since the Uruguay Round. The toughness of the TRIPS agreement has been widely criticised, and this is one area where progress has been made since Doha. IPR regimes by nature might seem to be a concern for multilateral negotiations, whether at the WTO or WIPO, but RTAs can serve as a forum in which countries are persuaded to make modifications to their IPR rules that then apply *erga omnes*.<sup>26</sup>

The WTO TRIPS agreement is the key agreement in this area. Formally it does not contain any country specific obligations or schedules once transition periods are past. However there is some “wiggle room”. RTAs may be an occasion in which this is pinned down. TRIPs, for example, leaves open the question of the exhaustion of patent rights.

India has strengthened its intellectual property rights (IPR) regime in recent years and has Agreement on Trade-Related Intellectual Property Rights (TRIPS)-compliant laws in place. However, there are still a few controversies about a few of the IPR provisions and concerns about the implementation regime, though previous EU-India WTO disputes appear to have been settled. EU pharmaceutical firms still complain about the nature of Indian pharmaceutical protection, but “piracy” appears to be less of an issue than in many other countries. Protection of traditional knowledge is also an issue for both parties, along with geographical indicators.

### **3.7.2. Data**

India has shown the second highest increase (365%) in the number of resident patents filed over 1995-2004 amongst the top 15 patent offices, China having seen the fastest growth. In terms of non-resident filings, India has shown the 7<sup>th</sup> largest increase (105%) amongst the top 15 patent offices over 1995-2004. However, even as the growth has been impressive, the actual numbers are quite low by both global standards and over time in both cases.

As a WTO member, India is party to the TRIPS, which came into force in 1995. As part of its commitment to the WTO, India made its IPR regime TRIPS-compliant by 1 January 2005. An act to amend the Patent Act of 1970 was passed, which made the Indian patent regime TRIPS compliant.

### **3.7.3. Procedures and processes**

While India’s IPR regime is at present TRIPS compliant, its implementation falls short of expectations though there have been improvements in the implementation regime. The Indian industry itself has become more conscious of the IPR situation and has been pushing for IPR protection. For example, in audio visual (which is significantly affected by piracy), the film industry is now more conscious of IPR infringement and piracy and have been making representation to the government to strengthen the IPR regime. However, the IPR infrastructure is still inadequate,

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<sup>26</sup> Cf. Business methods and software patents in US Jordan.

procedures are slow and bureaucratic, and information on patents that have been granted is not readily available.

The number of patent applications in India has increased – a large number of them from the domestic industry – signalling a growth in the IP culture in India. India is also rapidly emerging as a centre of innovation and contract research, which requires a strong IPR regime. An implication of the new Patent Act of 2005 is that the Indian Pharmaceutical industry must innovate.

The most important and controversial element of the IPR legislation is the Patent (Amendment) Act 2005. The new act brought into effect a process patent regime. For EU pharmaceutical companies, the new process patent regime is a welcome development, though compulsory licenses may be a threat for them. Previously, India had protection only for product patents, which facilitated growth in the production of generic medicines by domestic pharmaceutical companies at low cost using the reverse engineering processes. The new Act does incorporate provisions of compulsory licensing as per the declaration on TRIPS and public health of 2003, which would enable India to produce and export any generic medicine produced under a compulsory licence to export to other countries without sufficient manufacturing capacity. Civil society organisations, however, point out that the process of compulsory licenses is quite bureaucratic. To date, no compulsory license for any drug has been issued in India.

A data exclusivity clause ensures that for a fixed period of time, drug regulatory authorities do not allow the registration files of an originator to be used to register a therapeutically equivalent generic version of that medicine. Lack of data protection and exclusivity is a major concern for a number of European pharmaceutical companies in India (e.g. Astra Zeneca, GSK). The Government of India has established an inter-ministerial committee to consider steps necessary to ensure India's compliance with its obligations to the TRIPS agreement.

India has permitted pre-grant opposition to patent applications in addition to the post-grant opposition in the 2005 Patent Amendment Act. EU pharmaceutical companies contend that India's generic drug companies are using this provision to delay the grant of patents by lodging serial pre-grant oppositions to delay the granting of patents. Patent officials in India point out that the pre-grant opposition clause has been introduced to help patent examiners so that they have complete information on a patent application. They further point out that the EPO has a similar provision, known as representation, which is pre-grant opposition without any hearing.

The problem of piracy exists in India, though not on as large a scale as in South East Asia. Though no definite estimate is available, the EU (mainly UK) publishing firms in India lose a huge sum of money every year due to piracy and illegal shipment of books. The Indian government's stance is that the implementation regime is being strengthened. The other industry affected by poor IPR implementation and piracy is the IT sector, which is covered under the Copyright Act.

India is a part of the friends of geographical indications. Its position is that the additional protection that is given to wines and spirits should be extended to other products such as traditional Indian textiles as well.

At present Indian IPR laws forbid patenting of Traditional Knowledge (TK). India may ask the EU to recognise its sensitivity on the TK issue in an FTA.

### **3.7.4. Issues for possible negotiation**

In spite of implementation-related problems and barriers such as piracy and lack of data protection, the Indian patent regime is becoming stronger. Indian government and pharmaceutical companies have also realised the benefits of IPR protection. The EU should probably continue to engage with and provide technical assistance to India on this. Further, there is perhaps a need to ensure that access to essential medicines is not hindered by a stronger IP culture. India may ask for sensitivity from the EU on India's need to protect its traditional knowledge and GI for some of its products.

## **3.8. COMPETITION POLICY**

### **3.8.1. Background and Issues**

Trade and competition has been a highly controversial issue in the Doha Round with India publicly opposing the EU position. However, the Indian position is not necessarily opposed to a link between trade policy and competition policy.

India was a consistent opponent of the inclusion of trade and competition issues in the Doha agreement. It may seem paradoxical therefore that the HLG study identifies competition issues as a priority for India in an FTA. However as Holmes et al. (2003)<sup>27</sup> have shown, India's position at the WTO was less far removed from that of the EU than appeared from the public declarations.

### **3.8.2. Procedures and process in India**

India has just adopted a new law whose wording has been widely welcomed. But there are some doubts about the effectiveness of its enforcement.<sup>28</sup>

There are few controversial issues. Other trading partners have accused India of using accusations of predatory pricing to restrict trade, but the Supreme Court has curbed this. Furthermore, state trading and the "canalisation of imports" has been identified by the EU as a potential problem, but it affects few products

### **3.8.3. Issues for possible negotiation**

It is not clear how far negotiations might go in this area. The standard competition provisions of an EU FTA would not seem to pose major challenges for India. A clause confirming that both parties would have a competition law would seem easy to agree

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<sup>27</sup> P. Holmes, S.J. Evenett, J.H. Mathis, & T.C.A. Anant "The EU and India on Competition Policy at the WTO: Is There a Common Ground?" in Bridging the Differences, Analyses of Five Issues of the WTO Agenda eds L.A. Winters, P.S. Mehta CUTS, Jaipur 2003 available at <http://www.evenett.com/chapters/compfinaljune.pdf>

<sup>28</sup> See P. Mehta 2003, <http://www.thehindubusinessline.com/2003/01/10/stories/2003011000050800.htm>.

on. Details of the operation of the systems would seem beyond the scope of an FTA. India might wish to see more on competition and information exchange. Part 4 and Annex 4 identify a number of further issues that could be of interest to India.

## 4. EU-India FTA - Implementation Issues

### *Introduction*

This part discusses the scope of implementation of the deep integration issues discussed in Part III. The Singapore issues of competition policy, investment policy, trade facilitation and government procurement have all been discussed at the WTO and India has not always been comfortable with some of the proposals made. While countries have agreed to negotiate on trade facilitation at the WTO platform, the other issues remain problematic. This, however, does not necessarily mean that India will be equally uncomfortable with these other issues in the context of a bilateral FTA, for example, with the EU. The expected costs and benefits arising from agreements on these issues in a bilateral FTA may be different from those in multilateral agreements.

The first step in carrying out our analyses was to identify the scope and content of those issues that might potentially be included in the proposed FTA. Given that there is no concrete proposal on the table vis-à-vis the proposed EU-India FTA, the expected provisions on these issues are tentatively identified on the basis of similar agreements that the parties concerned have signed or are in the process of negotiating.

Since it is difficult to know the expected position of India on these issues in the context of a bilateral FTA with the EU, it was crucial to get expert feedback. The next step was to assess the existing situation in India in relation to these regulatory and institutional arrangements and any gaps from the proposed benchmarks. Based on these, an assessment is then made of any required legislative and institutional changes in India and the related expected benefits and costs of these regulatory and institutional reforms. Several bilateral agreements that EU has entered into in recent times have also been looked at to help identify likely issues for closer examination in this section.

Our analyses suggest that though India will have to incur costs for entering into a free trade agreement with the European Union, there will be benefits as well. And if one takes into account potential positive externalities from trade liberalisation and associated reforms, benefits will likely outweigh costs. This requires that a rules-based and predictable trading system is in place and a possible EU-India FTA as per the “deep integration” framework would be a necessary condition. However, a possible EU-India FTA may not be sufficient. While considering this free trade agreement with EU (and other such trade initiatives, including those at the multilateral level), Indian trade policy-makers must tackle two very important systemic issues.

First are the differences in policies and procedures between the centre and the states and among states, which are a major obstacle to economic integration.. There are institutions in place such as Inter-State Trade Council, which are not yet fully activated for this purpose. Secondly, there is a lack of detailed knowledge of likely impacts from specific policy changes driven by trade liberalisation, which requires more research – probably by academics or NGOs if it is to be credible.

## **4.1. Government Procurement**

### **4.1.1. Overview and Scope**

On government procurement in India our analysis suggests that, as a result of recent reforms, central government procurement policies and practices for goods are likely to be broadly compatible, particularly on transparency requirements, with the procurement rules that are normally agreed in FTAs. However, if they cover services, and state, municipal, and local government procurement in addition to central government procurement, then there might be difficulties. There is no systematic body of knowledge on the procurement policies and practices at these levels of government or of the many state enterprises. But enough is known to conclude that further and politically difficult reforms would be needed before procurement policies and practices consistent with FTA norms could be implemented. Many state governments and their agencies are known to discriminate on various grounds even among national firms.

Government procurement is here defined as any type of procurement of goods, services or a combination thereof, including works carried out by public entities of a country for governmental purposes and not with a view to commercial resale or with a view to use in the production of goods or the supply of services for commercial sale, unless otherwise specified. It includes procurement by such methods as purchase or lease, or rental or hire purchase, with or without an option to buy. Here “entities” means the public entities of a country, such as central, sub-central or local government entities, municipalities, public undertakings and all other similar entities.

The provisions on government procurement in any trade agreement establish an agreed framework of rights and obligations among its parties with respect to their national laws, regulations, procedures and practices in the area of government procurement. In respect of the procurement covered by an agreement, parties to that agreement are required to give the products, services and suppliers of any other party to the agreement treatment "no less favourable" than that they give to their domestic products, services and suppliers and not to discriminate among goods, services and suppliers of such parties.

India may not be comfortable with such a broad scope and coverage that extends to the local level. However, a high financial threshold for opening up procurement to EU firms (and indeed sheer lack of information) would reduce discomfort since contracts let by local governments at village levels for example are unlikely to qualify for such opening.

There are relevant rules in the General Financial Rules (GFR) 2005, such as Rule 144 for Reserved Items, which states that the central government has reserved all items of hand spun and hand woven textiles for exclusive purchase from Khadi Village Industries Commission, and other small-scale industrial units. This provision would be allowable under the WTO Agreement on Government Procurement (WTO GPA) Article V: Special and Differential Treatment.

Also relevant is the GFR 2005 Rule 142 Registration of Suppliers, which is largely up to the WTO GPA standard of Qualification of Suppliers Article VIII. However, the only time that government procurement tenders are published internationally is when

the goods of the required quality etc. are not available in the country. When such goods are available in the country, there is no international advertisement, which serves to restrict international suppliers and competition and thus may violate WTO National Treatment rules. In addition the General Financial Rules does not meet the requirements of Article XVIII of the WTO GPA “Information and Review as regards Obligations of Entities”.

As stated in India’s submission to the WTO “Response to the Questionnaire on Government Procurement of Services” (1997) as a response to question 8 b “Are entities required to publish details of the contracts awarded and/or notify unsuccessful tenderers?”, India responded: “At present, there is no requirement to publish details of the contracts awarded.” It is likely, however, that India could commit to such a provision on the basis of the GFR 2005.

#### **4.1.2. Issues for Negotiation**

India has three main concerns with respect to opening up government procurement:

- National treatment requirement
- Definition and scope of government procurement
- Issue of procurement methods

Given its quasi-federal nature India is likely to wish to limit any agreement on national treatment for government procurement to purchases by the central government and not be extended to state and local government level or to state owned enterprises.

The real challenge for India lies however with respect to procurement methods. India’s position is that “procuring methods have no bearing on transparency and there should be no restriction on the choice of the procurement method other than those placed by domestic legislation”. Even with this position, some significant changes/reforms can take place, and they are explained below.

- ***Changing the system of bidding:*** India follows a two-envelope system under which bidders submit all administrative, qualification-related and technical information in one envelope and the price in another envelope. The purpose is to avoid pressure to consider non-performing attractive bids (in terms of price quotation). In theory, it is perfect. In practice, it delays processing of bids (the longer the delay, the less is the perceived integrity) and encourages under-bidding, bid rigging and corruption. More often than not, price envelopes are opened first and a set of lowest bidders are selected. Following that, technical bids are opened and even if a bidders technical bid (including administration- and qualification-related issues) is not good, it might get selected on account of low price quotation. According to a World Bank/CII (Confederation of Indian Industries) survey of 210 private sector firms in 1999, a bribe of two to 25 percent of the price is necessary to secure government contracts. This suggests that the process of bid opening could be reversed. First technical bids should be opened, followed by financial bids.

- ***Introducing a standard tender document:*** In India, there is no standardised tender document. Different ministries and agencies use their own tender documents. According to one estimate, there are more than 150 different contract formats used by the government and its agencies. This can create confusion and lead to corruption. All the basic features of a standard tender document (such as qualification requirements, selection criteria, terms of payments, dispute settlement mechanism) could be streamlined into one standard tender document based on the Standard Bidding Document of the World Bank.
- ***Removing the process of negotiation:*** A practice in the Indian procurement system is to ask the bidder to reduce the quoted price without any changes in the other conditions of the bid. Instructions regarding negotiation of price with the lowest or with others as well are confusing. Many ministries and agencies issue them. Negotiations could be permitted only in exceptional cases (and after the appraisal of technical bids) and be carried out by a committee of experts, including those from other ministries and agencies other than the concerned ministry/agency.
- ***Introducing a functioning dispute settlement mechanism:*** Disputes relating to procurement by the central government are settled by the DGS&D by following the process of arbitration unless a dispute is settled through conciliation.

In order to introduce the above-stated changes/reforms, the DGS&D could be made the focal point on all issues relating to procurement by the central government. Similar counterparts are to be created at the state level and these bodies could coordinate with the DGS&D. The Central Vigilance Commission could be empowered to monitor the cost effectiveness of a standardised system of government procurement. The Comptroller Auditor General also needs to intervene to ensure accountability in the award of contracts and procurement decisions. Taking into account the above-stated changes/reforms, it would seem that widespread introduction of e-procurement is ideally required in India.

#### **4.1.3. Possible Benefits and Costs**

Besides introducing competition in the system, reducing delays, etc., standardisation of the government procurement system will enable:

- Those engaged in procurement activities to perform their duties, within the confines of their organisation's procurement policy, in a uniform and generic manner.
- Procurement documents to be readily complied with in a uniform and generic manner.
- Curricula to be developed to capacitate those engaged in a range of procurement activities.

There will be considerable benefits for India in introducing a standardised system of government procurement through the application of information technology at all levels of this market.

However, there are costs as well. India is yet to have a coordinated implementation of its e-procurement initiative, and this has resulted in delays and corruption. There is no ready estimate of costs to be incurred in the widespread introduction of e-procurement in India. However, the implementation of National E-governance Plan 2003-07 is estimated to cost US\$3bn. Twenty-five projects are being implemented under this Plan. Out of these 25 projects, there are seven initiatives on Integrated Services and e-procurement is one of them.

Thus, looking beyond conventional benefits (such as reduction in delays, corruption, etc), there could be further considerable benefits in India with comparatively little costs on account of a widespread introduction of e-procurement in the system of government procurement at all levels. India could easily achieve its goal of ten percent annual growth due to reforms in this area alone. However, if national treatment to EU firms is restricted to central government procurement only, it is unlikely to bring significant benefits to either EU producers or Indian purchasers unless there are other reforms. The question, then, is whether an FTA negotiation provides enough leverage to bring about this wider reform, even if both parties want it.

## **4.2. Services**

### **4.2.1. Overview and Scope**

The services sector is one of the most important offensive areas of interest for India in any FTA. India, which has experienced robust growth in its services sector in recent years, particularly in the export sector, is hoping to make some real gains by negotiating an FTA with the EU. The EU, for its part, is keen to see India further liberalise its foreign direct investment (FDI) regime by raising the equity cap in some sectors and opening up closed sectors such as legal and accountancy.

Apart from barriers to market access for European service providers, inadequate regulation in India is another critical area. Except for a few sectors, services transactions are either over or under regulated. Financial, telecommunication, and insurance sectors, for instance, are adequately regulated. However, for a large number of professional services, there is no independent sectoral regulator. This not only causes problems for domestic consumers and professionals, but also often creates barriers for foreign service providers.

### **4.2.2. Issues for Negotiation**

Indian service sectors are grouped into three categories: those sectors which are substantially liberalised, and face no explicit barriers; sectors that are moderately liberalised with a few explicit barriers; and those that remain largely closed to foreign competition. Therefore, there is scope for further negotiation to open up many of the moderately liberalised and closed sectors in India. The following specific issues in the services sector could be considered for negotiations under the EU-India FTA framework:

- *Computer and related service:* There is a lack of an independent regulator in the computer and related services sector in India. Its job would be to regulate the different functions of this sector, including the protection of intellectual property rights. A functioning regulatory mechanism would bring more certainty to the operations of this sector in India and that will particularly help foreign service providers in taking investment and other business decisions.
- *Telecom:* There are licensing restrictions on telecom service providers along with policy uncertainty on tariff and inter-connect regimes.
- *Construction:* The whole sector, domestic or foreign, suffers from the difficulty of access to land. Institutional problems stem from the use of the Urban Land Ceiling and Regulation Act (ULCRA) in a number of states. Collaboration with domestic industry and national treatment for EU providers might accelerate change. Also, there is lack of transparency and a level playing field is yet to be provided to foreign service providers in the award of government contracts.
- *Health:* There is a lack of standardisation of the accreditation system for healthcare professionals. Also, there is no independent regulator in this sector.
- *Banking and other financial services:* The treatment of banking services as in the India-Singapore Comprehensive Economic Cooperation Agreement (CECA) could be replicated in the proposed EU-India FTA and thus more branch licenses could be allocated and fewer restrictions put on European banks.
- *Insurance:* Cap on FDI in insurance sector could be raised from 26 percent to 49 percent to allow more participation of EU companies in the Indian insurance sector.
- *Distribution:* Entry of EU firms in the retail segment could be allowed by raising the FDI restriction. Multiple laws and regulations prevalent in the retail sector could be streamlined. Also, there is requirement for an independent regulator and appropriate legislation on e-commerce.
- *Education:* Formal recognition of autonomously functioning EU institutes by the All India Council for Technical Education (AICTE) requires changes in the University Grants Commission (UGC) Act of 1956 or in the Foreign Educational Institutions Bill of 2005.
- *Postal and courier services:* Proposals before Indian Parliament to give the Dept of Posts a monopoly on letters/packages below 500g and impose a universal service levy on private providers.
- *Legal:* Opening up to EU providers would require changes in the Advocates Act and the Bar Council of India Rules. Also FDI could be allowed in this sector. Government is already moving in this direction.

- *Accountancy*: Getting rid of regulatory restrictions on firm size and practice and entering into MRAs (proessional body to professional body), and allowing FDI are the major issues in this sector.

### **4.2.3. Possible Benefits and Costs**

Broadly speaking, the removal of stringent regulatory barriers and the greater participation of EU service providers by allowing FDI in the country should lead to easy accessibility of services in India. The onus of providing services would to some extent shift from the government to increased participation of private players. The benefits from implementing sectoral reform programmes are expected to create a multiplier effect on agriculture, manufacturing and food processing sectors in the country. Competition among a larger numbers of service providers would help to improve efficiency of these sectors and also generate employment. Whether these would be trade creating or diverting will depend on how far the sectors are already open, how globally efficient EU providers are and the degree of competitive advantage any preferential liberalisation gives to EU providers. Given low levels of access to foreign providers generally and the general competitiveness of EU providers, trade creation is at least probable.

For sectors like education, implementing certain reform measures would make foreign education/certification more accessible to Indian students, which, while costly, will improve quality, efficiency and accountability in the educational institutes.

The opening up of closed sectors like legal and accountancy services would provide additional business opportunities in the country. Opening up the retail sector is expected to improve the supply chain and infrastructure.

However, all these proposed measures are associated with some political cost if the domestic rules and regulations are not tuned to protect sensitive domestic service providers from increased competition. In some sectors, like retail, local players may need to be given the opportunity to consolidate their position, perhaps aided by deeper capital markets, before they face full fledged competition from established European players. Otherwise, the benefits of higher exports through service sector liberalisation would likely be perceived as being offset by direct and early job losses in some domestic sectors.

## **4.3. Investment Policy**

### **4.3.1. Overview and Scope**

The investment-related provisions in free trade agreements (FTAs) concluded by the EU are generally not as comprehensive as those of traditional Bilateral Investment Treaties (BITs).

As far as policies and procedures relating to FDI (foreign direct investment) are concerned, the Indian Government has been liberalising the country's investment regime since 1991. Many areas which were not to be opened (in 1991) have since been liberalised, and the FDI cap has been raised gradually (from 24 percent to 49

percent, and then to 76 percent and even 100 percent). However, the actual realization of FDI compared to mere approvals has remained under 50 percent. The main reason behind this lies in the system of economic governance in India with differing legislative requirements at central and state government levels giving rise to procedural and implementation problems.

Indian states also provide a number of incentives for attracting investment (domestic as well as foreign) such as tax concessions, concessions on land and infrastructure costs, environmental standards and in some cases exemptions from labour laws. In most cases, there is no discrimination between domestic and foreign investment while providing such incentives. However, sometimes the number and type of incentives at various levels (among different states) may create confusion among potential investors.

At present, India is engaged in a number of bilateral and regional free trade agreements to further liberalise its trade and investment regime. India has signed Bilateral Investment Promotion & Protection Agreement (BIPAs) with many EU Member States. These agreements typically contain clauses on investment promotion and protection, national treatment and most favoured nation treatment, expropriation, compensation for losses, repatriation of investment, dispute settlement between companies and the state, and between states.

#### **4.3.2. Issues for Negotiation**

India needs a huge amount of foreign investment to improve its infrastructure and other related facilities. The central government and various state governments are reforming their policies and providing concessions, which are often crisscrossing and thus, potentially confusing, to attract domestic and foreign investment. Furthermore, the process of decision-making is not clear. Division of powers and sectors between the centre and states poses some problems in implementing policies. Absence of a single information window poses another problem.

In India, there are two main types of barriers faced by foreign investors: policy-related and procedural. A few of the policy-related barriers are small-scale industries (SSI) reservation, special economic zones, and a non-transparent and burdensome tax structure.

However, the majority of policies governing FDI have been reformed and the government is open to any suggestions encouraging foreign investment. While in general a political consensus has emerged with little opposition to increased FDI, there remain some concerns with respect to its ability to generate new employment and to attract new technologies, and whether it might replace existing industries.

The policy for reservation for SSI was previously based on protecting numerous small-scale domestic producers and also on employment considerations. The government has, since the initiation of liberalisation in 1991, recognised the need for the dereservation of such industries on the grounds of promoting efficiency and scale economies. The issue of reservation/dereservation of products is examined on a regular basis by an advisory committee on reservation constituted under the Industries Development and Regulation Act (IDR) Act 1951. As a consequence, the number of

products under reservation has fallen gradually from 836 in 1989 to 298 as of 16 May 2006.

However, procedures are a greater problem. There is a multiplicity of procedures and too many agencies are dealing with investment clearances, especially at state levels.

Implementation of most of the policies and procedures for attracting investment in most of the industries fall to the states and hence political and administrative efficiency at the state level has a bearing on its performance. Land acquisition and land allotment is a very tricky issue with major political repercussions. Absence of a comprehensive and transparent rehabilitation and resettlement (R&R) policy further complicates the issue of transforming land use patterns from agricultural to industrial use.

Given that recently there have been protests against the acquisition of agricultural land for special economic zones (SEZs) and other industries, the Government of India (in consultation with the states) is contemplating a comprehensive policy on land use, including rehabilitation and resettlement of displaced people, based on a detailed social impact analysis of investment projects (particularly for those projects with heavy use of natural resources). Furthermore, the government is considering amending the Land Acquisition Act of 1894.

Environmental issues on any industrial project are highly sensitive and require careful scrutiny, both by the central and state governments. Both the central and state governments have enacted laws relating to environmental protection, which have made environmental clearance of industrial projects mandatory. Due to inefficiency and corruption, such clearances take longer and cost more than necessary.

#### **4.3.3. Possible Benefits and Costs**

India may be ready to go beyond a conventional FTA with some India-Singapore CECA-style provisions in the agreement with the EU, incorporating elements of deep integration). Such provisions would protect investment on both sides and once an agreement is signed between EU and India then it would be the responsibility of both the Government of India and the European Commission to abide by those provisions. India would benefit enormously from such an agreement at little or no cost.

A single window information system could be set up fairly easily in India which would greatly facilitate the decision-making process for investors. Nonetheless, the complexity of governance suggests that the practical tasks of gathering and collating up-to-date information may be harder to reform.

With regard to the imposition of performance requirements, India may continue to require provisions on local content, export conditions and employment, The current policy of the Indian government does include such provisions, but they are not prerequisites for access. Given the severity of unemployment and unbalanced regional development, it is perhaps not surprising from a political perspective that such provisions remain and will be difficult to remove.

It may not be possible for India to include provisions related to state controlled areas such as land and labour in the agreement, as they are restricted by constitutional state

jurisdiction and are politically sensitive. The costs (including the social and political costs) of doing so may not be outweighed by the benefits that may arise.

A dispute settlement system to protect investment has to be negotiated. However, since the India-Singapore CECA already includes such a system, it would be fairly straightforward to negotiate one with the EU in the proposed FTA. Indeed, the costs of implementing such a system would be offset by the reduced uncertainty and other hazards relating to investment.

## **4.4. Trade Facilitation**

### **4.4.1. Overview and Scope**

The EU has made it clear that growth in world trade must be matched by strong and effective trade facilitation (TF) measures. Accordingly, the EU has implemented more comprehensive and detailed TF elements in FTAs with Mexico and other countries.

Despite its negotiations at the WTO, India's achievements on TF are below the standards that might be agreed by the WTO or in an FTA with the EU. Some of the issues like regional transport networks, right to transit, or the facilities at inland custom stations are under discussion in the WTO and may not be relevant in the context of the proposed EU-India FTA because they are essentially *erga omnes* provisions.

India's achievement in implementing TF measures may not be excellent, but it has unilaterally embarked upon a series of TF measures since 1998. The Electronic Data Interchange (EDI) system has been introduced, and is now operational at 23 major customs locations handling nearly 75 percent of the country's international trade. The scale of examination for certain items has been reduced and the examination procedure has been simplified. A fast track clearance system has also been introduced under which certain categories of importers are allowed to pay duty and clear imported goods on the basis of their self-assessment. The government is also working to simplify and modernise customs procedures by adopting an Accelerated Customs Clearance Procedure (ACCP) based on the self-assessment principle and post-clearance audit, which will be available to eligible traders subject to certain conditions. Another important step that has been taken is the harmonisation of the customs code which has reduced documentation. The information required by the exporter and importer is also published by the relevant authorities. Electronic media is also increasingly utilised by various authorities to disseminate information. Several initiatives have also been taken to provide training to officers engaged in assessment and inspection so that they can deal with emerging situations as a result of ongoing reform programmes. India has an excellent mechanism dealing with appeals, protesting decision of authorities dealing with customs and related assessment problems<sup>29</sup>.

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<sup>29</sup> See Chaturverji (2006), Taneja,(2004), and UNESCAP, Alignment of Trade Documents and Procedures of India.

However, India still lacks a single administrative data set for exports and imports, or a single one-time-presentation to one agency. Current performance of India's ports and airports is also far below global norms and impedes greater integration into the global economy. There is also no standard processing time for cargoes in India. Though the scheme of advance rulings on classification, valuation and applicability became fully operational on February 2004, the scope has thus far been limited only to foreign firms, which invest in India through joint ventures or wholly owned subsidiaries. The provision is not applicable to Indian-owned companies. At present, there is no officially designated enquiry point for traders. There is also no formal mechanism for consultation between interested groups.

#### **4.4.2. Issues for Negotiation**

Despite India's unilateral reforms in many areas of TF, there is room for further significant changes, which include the following:

##### Transparency Issues

- *Setting up a single enquiry point:* A single window facility and web portal for easy access of information on all trade-related issues needs to be established.
- *Revision of export/import manuals:* The respective export/import authorities need to revise their manuals and supplementary instructions and notifications on an annual basis.
- *Better communication among export/import facilitating bodies:* Communication needs to be enhanced further to avoid discrepancies. Risk management tools need to be in place at all customs stations so that the system is faster and more transparent.

##### Trade Procedures and Requirements

- *Streamlining of different state legislations:* Rules and legislation prevailing in different states need to be streamlined and made more coherent to facilitate export and import from different states.
- *Customs development programme:* The customs development programme needs to be accelerated so that all customs offices in the country are connected by the EDI system and all customs activities take place in an automated manner. To meet international standards as set by the revised Kyoto Convention, India also needs to upgrade its existing EDI system to a totally paperless mechanism for declaration. Without such comprehensive automation, it would not be possible for India to substantially reduce documentation requirements and move towards a fully compliant EDI regime.
- *Integrating different sectors of the economy:* Greater integration of the banking and insurance sectors and the overall financial system is needed to ensure availability of loans and other financial support to promote trade.

#### 4.4.3. Possible Benefits and Costs

The benefits of TF reforms for India are numerous. Providing single window and web portal facilities along with helping exporters and importers easily access information will enable the use of single entry/exit customs documents or data messages based on international standards. The establishment of a simple mechanism for appeals on customs-related issues would lead to the speedy redress of disputes over exports and imports.

There are further policy measures that India could unilaterally undertake that would also help to facilitate trade, but which would not come under the remit of an FTA. For example:

- *Augmentation of basic infrastructure:* Basic infrastructure like roads, railways and ports need to be developed further to ensure faster movement of cargoes among the states and also to ensure reduction of transaction costs through reduction of time and expenses related to transport of goods. Building basic infrastructure is likely to have a positive spillover effect on the economy through the reduction of export and import transport time.
- *Simplification and rationalisation of tax structure:* Tax structure among the states needs to be simplified, rationalised and streamlined to a large extent so that inter-state differences are minimised. Value Added Tax (VAT) system (allowing a common tax rate in all the states) needs to be adhered by all state governments so that differences in sales tax rates in different states do not prohibit trade and commerce. Over time, instead of several taxes, India could move towards a uniform “goods and services tax” (GST). Simplification of state legislation and tax bureaucracy would impart more transparency and predictability into the system, leading to an increase in revenue generation, as tax evasion could be minimised and other discrepancies in the tax system eliminated.

However, the costs associated with implementing some of the TF measures in India may be high. Establishment of a national focal point and state-based enquiry points requires full automation of the system and thus significant investment. Rationalisation of the tax structure, though not a lengthy process, would mean financial and other resources need to be made available at the state level to calculate the impact of restructuring the tax and legislative structure. Augmentation of basic infrastructure in the country like roads, railways and ports is both time consuming and also requires huge investment. Access to EU-based construction, consultancy and financial services companies through an FTA-led liberalisation will help, but the challenges remain daunting. The key issues in this area, if tackled, would generate essentially erga omnes benefits. The only reasons for dealing with them in an FTA would be if there were no possibility of a WTO solution or if any bilateral benefits of an FTA were prevented by TF failures.

## **4.5. Trade Defence**

### **4.5.1. Overview and Scope**

India is now the world's top user of anti-dumping duties and also the second most active user against the EU, while the EU is the number two target for India, even though the actual totals are modest and have been declining over time. (About 30% of Indian measures in force in 2005 were against the EU and about 15% of total measures against the EU were by India.)

It is also observed that many Indian exports are increasingly being subjected to countervailing measures in different importing countries, including in the EU. In India, there exist a number of export promotion schemes under the aegis of the Ministry of Commerce and the Ministry of Finance. In this respect (that is subsidies for export promotion), India is protected by Annex VII of the WTO Agreement on Subsidies and Countervailing Measures, because its per capita gross national product is less than US\$ 1,000. However, this provision does not provide blanket immunity to Indian exports from countervailing actions by other countries. If such exports cause material injury to domestic industries in importing countries, then they can be subjected to countervailing actions. Thus, India's concern in this regard is not so much about the amount of subsidies for export promotion but on the issue of "manner of calculating subsidies (by the importing countries) while imposing countervailing measures".

Among all these export promotion schemes, the most controversial one is the duty entitlement passbook scheme. Approximately 52 percent of Indian exports (in terms of their value) enjoy some kind of subsidies on account of this scheme. In order to avail benefits under this scheme, an exporter does not necessarily have to establish a direct connection between imported inputs and what is consumed in the production process. The Indian government is considering a replacement of this scheme with a suitable alternative.

As far as safeguards are concerned, they are more comprehensive than anti-dumping measures, as they target all imports of a particular commodity, unlike anti-dumping investigations, which target only source-specific imports. Since 1997, India has initiated only 12 cases on safeguards and global trends show that safeguard measures are used less than anti-dumping measures.

### **4.5.2. Issues for Negotiation**

The only serious issue that India has with the EU vis-à-vis trade defence measures is the method of calculating subsidies for export promotion. India wants countervailable calculations to be based only on "excess remission/refund of duties". The EU and India could explore the possibility of introducing certain WTO+ elements in their bilateral FTA, such as mandatory lesser duty rule and the public interest test:

- *Mandatory use of lesser-duty rule:* Lesser duty is a duty which is no higher than what is necessary to offset any injury being suffered by the domestic industry. Both the EU and India practice the application of "lesser-duty". The Directorate General of Antidumping has always considered this rule to be mandatory. However, some AD practitioners in India claim that the Indian antidumping law,

as amended in 1995, may be interpreted otherwise, even though independent research seems to suggest that the mandatory lesser-duty rule is binding.

- *Introduction of public interest criterion:* Investigating authorities must consider public interest before imposing anti-dumping and other trade defence measures. This is necessary because many of these trade defence measures tend to be continued for too long. Consumers must not be asked to pay the price for the lack of commitment to consumer interests on the part of domestic producers. However, public interest is not consumer interest alone. A mandatory public interest test (in terms of an examination of the impact on economic operators) would ensure that the investigating authority gives due cognisance to the concerns expressed by various interested parties including exporters, importers, consumer organisations, user industry, etc.

In addition, there are several other important issues which the EU and India could discuss outside the scope of the FTA that will benefit both parties. A brief account of such issues is given below.

- *Calculation of dumping margin and determination of normal value:* The difference between the normal value and the export price is referred to as the “margin of dumping”. While this concept seems simple, there are several areas of discretion and anomalies that need to be addressed carefully in the context of normal value, export price and the comparison between the two.
- *Procedural improvements involving transactions between related parties:* While calculating normal value, it must be shown that the transactions are in the ordinary course of trade. Transactions made between related or affiliated parties need to be treated differently from transactions between unrelated and independent parties. The concept of “related parties” needs to be defined clearly.
- *Comparison between normal value and export price:* While making comparisons between normal value and the export price, the investigating authority could make adjustments for all the factors that affect the price comparability.
- *Zeroing in method:* For all transactions where the dumping margin is negative, the same must be accounted for in calculating the weighted average dumping margin.
- *Mandatory analysis of all injury parameters:* An investigating authority is required to consider all 15 factors mentioned in the WTO Agreement on Anti-dumping with regard to calculating injury to a domestic industry. There could be a guideline in this respect and injury assessment needs to be restricted to the product under consideration and not to the performance of the business enterprise as a whole.
- *Issue of causal link:* While determining the causal link, it would be useful to provide for an analysis with reference to the most efficient producer of the domestic industry. Such an approach can eliminate the scope for manipulation by the complainant domestic industry to project the injury on the least efficient producer.

### **4.5.3. Possible Benefits and Costs**

The European Union and India would do well to negotiate some WTO plus provisions with regard to the application of trade defence measures such as mandatory lesser duty rule and public interest test

## **4.6. Standards**

### **4.6.1. Overview and Scope**

Technical regulations and standards are important and vary from country to country. Arbitrary development and applications of standards can cause obstacles to trade. The WTO Agreement on Technical Barriers to Trade attempts to ensure that regulations, standards, testing and certification procedures do not create unnecessary obstacles, while recognizing the rights of member countries to adopt standards that they consider appropriate. Likewise, sanitary and phytosanitary measures (SPS) are receiving increasing attention within the framework of international trade. SPS measures are meant to ensure that imports do not undermine national health and safety. However, restrictions designed to uphold domestic safety standards can be misused as disguised protectionism. This risk has gained importance because tariffs as traditional measures of protection are covered by reduction commitments through the WTO negotiations and otherwise.

India, being a member of Codex Alimentarius Commission (CAC), has adopted the Codex standards, but it does not have any process for developing internal standards, although a National Codex Committee and a Central Committee for Food Standards exists. This has resulted in losing out on export opportunities, as domestic producers are unable to meet the requirements of international markets. The present situation is not satisfactory due to overburdening of limited resources and lack of general concerns about domestic as well as international standards. The country, therefore, has to prepare itself to develop SPS measures which are scientifically sound and when required, be able to challenge the SPS measures of trade partners on a scientific basis.

Thus, there is a need for standards to respond to market and regulatory needs. There are various bodies formulating standards in India, but the Bureau of Indian Standards (BIS) is the national body set up under the BIS Act, 1986. The functions of BIS are standards formulation and promotion, certification and testing, international cooperation and consumer affairs.

EU-India discussions on SPS and TBT issues have been characterised by problems experienced on both sides rather than merely the traditional issue of developed-country norms being perceived as obstacles to developing-country exports. However, a common characteristic of all EU FTAs is their emphasis on facilitating the application of the WTO SPS/TBT provisions. Only very rarely do the agreements contain individual provisions that go beyond WTO SPS/TBT commitments.

The India-Singapore Comprehensive Economic Cooperation Agreement (CECA), contains mutual recognition agreements (MRAs) on conformity and standards for four sectors: food, drugs, telecom and electric goods. It also contains a section on technical training for conformity assessment. India has MRAs with five other countries.

#### **4.6.2. Issues for Negotiation**

Both countries could reinforce cooperation through exchange of information on legislation, certification, inspection and accreditation procedures, by identifying obstacles to trade on account of standards and by seizing opportunities to simplify administrative requirements and procedures. In this context, countries could encourage co-operation between the European and Indian organisations responsible for standardisation, testing, certification, inspections and accreditation.

There is also a need to explore the possibility of exchanging best practices between the EU Member States and Indian authorities on market surveillance and inspection activities.

The negotiation could also focus on India's needs to develop/improve research and development (R&D) and testing facilities, licensing procedures, credit facilities, easy information availability, storage facilities, and packaging systems.

#### **4.6.3. Possible Benefits and Costs**

As the demand for high-value food products is growing rapidly, countries that approach standards compliance as part of an overall competitive strategy are likely to thrive. Failure to address SPS problems or concerns may undermine an industry's access to remunerative international markets.

India could profit by viewing higher standards as a stimulus for investments in supply-chain modernisation. Further, the compliance process can result in new forms of competitive advantages and may contribute to more sustainable and profitable trade over a long term.

Other potential benefits include access to more remunerative markets and supply chains, greater efficiency leading to lower costs, less wastage during production process, and reduced incidence of product inspection and detention abroad. The companies that ensure higher standards would also stand to benefit from the enhancement of product quality, in turn leading to improved reputation of the firm and the country. Compliance with SPS and TBT measures should also attempt to ensure that the regulations, standards, testing and certification procedures do not create unnecessary obstacles during trade between the two nations, while at the same time recognising the rights of each country to adopt standards that it considers appropriate.

## **4.7. Intellectual Property Rights**

### **4.7.1. Overview and Scope**

In regard to intellectual property rights, the necessary requirement in the current FTAs that the EU has with countries such as Mexico and South Africa is that the patent regime of a party applies the WTO Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPs) for IPR protection. This does not really mean much for a country like India, as it has a TRIPs-compliant patent regime.

Nevertheless, some of the EU's bilateral agreements go beyond the minimum requirements set out in the WTO TRIPs Agreement. For instance, in the EU-Egypt Agreement, it has been mentioned that 'Parties shall grant and ensure adequate and effective protection of intellectual property rights in accordance with the prevailing international standards, including effective means of enforcing such rights'. In some other agreements, however, the parties are to enforce protection of IPRs with 'the highest international standards'.

There is a well-established statutory, administrative and judicial framework to safeguard intellectual property rights in India, whether they relate to patents, trademarks, copyright or industrial designs. Moreover, India is a party to the WTO TRIPs Agreement and with recent amendments to its Patent Act of 1970, it has a TRIPs-compliant patent system. However, there is scope for improvement in its enforcement. The implementation of India's commitments in regard to other multilateral instruments is weaker. Hence, the inclusion of these other instruments in a trade agreement would mean that India will have to take them more seriously, which will mean even higher implementation costs at a time when the country is already struggling to implement its TRIPs obligations. Hence, the implementation costs for India in this area would depend on additional obligations that might have to be taken. Most of the stakeholders interviewed in India opined against accepting any TRIPs-plus obligations in a possible EU-India FTA.

India's academic infrastructure is also not adequate to produce the large number of IPR professionals that India requires.

### **4.7.2. Issues for Negotiation**

Negotiations between the two countries on issues related to IPR could focus on the following:

- The need to re-visit India's existing legislations considering new and emerging issues such as Internet piracy, data protection laws and circumvention of technological measures
- The quantum of technical and financial assistance that India might need to effectively put in force the country's current obligation, including preparation for a stronger and more predictable IPR regime

Both countries could reinforce cooperation through exchange of information on legislation, enforcement, registration and registration procedures, by identifying

obstacles to trade and by seizing opportunities to simplify administrative requirements and procedures.

### **4.7.3. Possible Benefits and Costs**

IPR is playing an increasingly important role, such that if India is able to guarantee the international community a strong and predictable IP protection regime on the basis of a set of enforceable criteria then the benefits to the country could be immeasurable. Empirical evidence around the world shows positive correlation between a strong IP regime and increased inflow of foreign direct investment.

Stronger IPRs in India will greatly benefit software companies across sectors and will encourage greater product development in India. At present, the Indian software industry employs over 500,000 software engineers, and software services in India have gained a worldwide reputation. A growing desire for strong levels of protection for intellectual property has encouraged foreign investment in India, with many companies choosing to either set up their own facilities in India or to outsource a large part of their business.

For India it is estimated by the Business Software Alliance (IDC-BSA) study that a 10-point reduction in the current 74 percent piracy rate would have a tremendous impact on the domestic front, enabling the IT sector (excluding software and services exports) to grow from US\$7.4bn to US\$19.5bn. On top of an already impressive growth rate, it will add 115,000 jobs, contribute US\$5.9bn to gross domestic product, add US\$386mn in taxes and US\$8.2bn in revenues to local vendors. The IDC-BSA study has also found that the global IT sector, currently projected to grow by 33 percent between 2004 and 2009, could instead grow by 45 percent over the same period with a 10-point reduction in software piracy. Thus, the importance of protection of IPRs for the growth and development of industrial sector (not just the IT sector) cannot be understated.

An adequate and effective IPR regime in the country can create jobs, provide taxable income to the government and at the same time attract foreign investment by assuring protection for investors' intellectual property. All these developments would, thus, create a spillover that would, in turn, lead to greater domestic growth. More importantly, if the country sticks to its weak implementation regime then it provides almost no incentive for people to be creative and innovative, nor do they attract new investment (including new technologies).

## **4.8. Competition Policy**

### **4.8.1. Overview and Scope**

The EU has included provisions on competition issues in all the FTAs it has signed with other countries and is seeking provisions on competition issues in its proposed new agreements. The content of the competition provisions in the agreements, however, seems related to the degree to which the EU's trading partners had domestic competition legislation in place when the FTAs were signed. The competition issues are becoming more elaborate with time.

Looking at the existing EU FTAs, the following issues seem important in the context of the proposed EU-India FTA:

- Effectiveness of Indian Competition Law
- Substantive Provisions in the Competition Law
- Mutual Recognition of Legislation
- Extra-territorial Provisions
- Abuse of Dominant Position by Domestic Incumbent Firms
- Market Access Barriers
- Cooperation and Consultation
- Government Policies and Competition
- Non-discrimination
- State Aid
- State Enterprises

India has had a competition law: the Monopolies & Restrictive Trade Practices (MRTP) Act since 1969. However, the MRTP Act did not deliver as expected. Weaknesses in the structure of the Act and the composition of the MRTP Commission were among the key reasons for its ineffectiveness. The economic reforms undertaken since the early 1990s significantly changed the economic environment. This led to enactment of the Competition Act 2002 and the establishment of the Competition Commission of India. The new law is arguably a better piece of legislation as compared to the MRTP Act. The Competition Act is, however, facing challenge even before becoming fully operational. Pursuant to litigation, the Government has proposed amendments to the Competition Act, which are under consideration by the Indian Parliament. Despite the amendments proposed, concerns with respect to effective enforcement of the new law remain. While the current law is not without controversy and certain limitations, no competition law is ever perfect, and the law evolves through time, experience, and development of case law. At this stage, therefore, it would be naïve to comment upon the effectiveness of the new law.

There are concerns relating to the use of predatory pricing provisions where dumping is suspected. Predatory pricing, strictly speaking is pricing below costs with the intention of driving out rival producers. In contrast, dumping is simply pricing exports below “normal value”, not below costs and anti-dumping measure is taken when a connection between dumping and injury to domestic producers is established.

Of late, there has been a proliferation of anti-dumping (AD) in both developed and developing countries. It has been suggested that applying stricter standards than those required in predatory pricing cases would limit the misuse of anti-dumping for protectionist purposes. However, both the EU and the US have opposed reform of the anti-dumping agreement to make it consistent with antitrust principles. Given the stricter standards applied in predatory pricing cases, as against dumping, the concern about misuse of predatory pricing provisions does not seem to materialise.

In fact, it is easy to prove dumping and in several cases, the anti-dumping authority in India accepted an increase in foreign firms’ market share (which was only to be expected in a period of trade liberalisation) as evidence of injury, even though Indian industry’s sales and profits were increasing at the same time. Available research

evidence suggests that in most cases, AD remedies have been used to protect Indian industries, which inflicted higher import costs on user industries, as it is mainly intermediate goods industries that succeeded in obtaining AD protection. The Indian anti-dumping regime is therefore likely to have harmed rather than promoted competition.

Additionally, given the (mis) use of anti-dumping measures, the trade department and related government agencies need to be encouraged to apply competition principles in administering anti-dumping and other trade policy measures. The adherence to these principles would be in addition to WTO rules and not in derogation to them. The competition principles, presently under consideration as part of the process of adoption of National Competition Policy, are proposed to be the underlying tool to implement economic reforms. They seek to bring coherence to various government policies and measures, to enhance competition in the domestic market and promote a culture of competition.

Abuse of dominant position by domestic incumbent firms has been identified as another major competition problem in developing countries. CUTS had undertaken a comprehensive study of the competition scenario in India, which brings out key findings in this respect. The study examined changes in concentration for select industries grouped under four broad categories: (1) consumer non-durable goods (2) consumer durable goods (3) intermediate goods and (4) capital goods. It is observed that one or two firms dominate industries that have experienced an increase in concentration levels. Both domestic as well as foreign owned firms have taken dominant positions. The CCI will have to keep a watch on the behaviour of these dominant firms. An effective competition regime and the cooperation arrangement with the EU would be useful in tackling abuse of dominance exercised by domestic incumbent firms.

'Market access barriers' is one of the substantive issues that is to be addressed. In the case of Indian companies' access to EU market, apart from non-tariff barriers, there have been some cases of private barriers to market access. Tackling such restrictive business practices, which could be harmful to Indian exports, could be one of the agenda items. One rationale for having competition provisions in the trade agreements is to guarantee a level playing field. Therefore, Indian companies could complain to the EC when they encounter anti-competitive behaviour in EU market and get the problem addressed. The EU companies should be able to do the same in the Indian market and have their problem appropriately addressed.

The Indian competition law gives a mandate to engage in cooperation arrangements with other countries. However, as of now, the competition authority cannot do this directly but needs to seek approval of the Government. Hence, India may not be averse to having such arrangements with the EU. India is also actively seeking technical assistance in implementing its competition law effectively. However, India might have one problem. Given its capabilities and resources, Indian competition authorities may not be able to respond to the demands of the EU competition authority on information and other requirements. Moreover, as the Indian competition authority will be duty-bound to cooperate with the EU authority, this might lead to devoting a disproportionately larger proportion of its resources to cooperating with the EU, adversely affecting its own enforcement activities.

The thrust of economic reforms adopted in India since the early 1990s has been to allow for more competition and for the government to play the role of a facilitator rather than the controller of economic activity. However, in spite of these kinds of labels, policies are most often not framed and implemented in sympathy with the market process. There are several such examples: policies in relation to the operation of anti-dumping measures, inverted duty structure, etc. The reforms have been undertaken without a broader policy framework underlining the role of competition in the reform process. Against this background, the Government of India has taken certain initiatives to rationalise its role vis-à-vis market forces. Two separate committees have been set up to finalise the nuances of a National Competition Policy, which provide comprehensive policy instruments and strategic interventions to effectively generate a culture of competition in the domestic market and enhance the role of competition and competitive markets in Government policy making at the Central and State levels. The proposed EU-India FTA could take note of this development.

Indian competition law does not specifically mention terms like non-discrimination or national treatment, but the law explicitly provides for equal access to foreign natural and legal persons. Since equality before the law is a basic legal principle in India (unless otherwise specified), and foreigners have equal access, and competition law does not provide for discrimination on any grounds, the law may be considered to be non-discriminatory. However, discriminatory outcomes may arise due to the fact that the law enforcement is also to take account of public interest and development concerns, or policy directives of the Central Government. So far, there has not been any concern over misuse of such gateways in India. Hence, going by the experience of the Indian judiciary, such things are extremely unlikely to happen.

In India, state aid is not a part of competition policy or law. However, several loss-making government-owned companies survive on state aid, popularly referred to as 'budgetary support or subsidies'. These companies may or may not compete with private companies as some of them operate in sectors where private companies are non-existent or are not prominent. Even in sectors where private and government-owned companies are competing, private companies have never raised the issue of subsidies as a competition problem and such things have been generally considered a matter of government policy. Hence it would be extremely difficult for India to accept state aid as a competition policy issue and accept commitments to the extent accepted by the EU's other FTA partners. Complexities however might arise on issues of agricultural subsidies, as subsidies to farmers are not given directly to farmers in India. The government provides them subsidised inputs, particularly fertilizers and electricity. Though the EU might consider them non-agricultural subsidies, India may want them to be treated otherwise.

As for discrimination against third parties in favour of state monopolies of a commercial character', most of the EU FTAs stipulate that such discrimination could be eliminated after a transitional period of five years. Within the same timeframe, no measures that disturb trade by granting special or exclusive treatment to (public) enterprises shall be adopted or maintained.

## 4.8.2. Issues for Negotiation

The following changes could be made in the Indian competition regime:

- Indian competition law gives a mandate to engage in cooperation arrangements with other countries. However, the fact that the competition authority cannot do it directly, but needs to seek approval of the Government seems a restrictive provision. CCI could instead be allowed to enter into cooperation arrangements on its own.
- Given the large-scale (ab)use of anti-dumping provisions by Indian authorities and the fact that such actions have been taken in industries where there exists high concentration and monopolies, it would be worthwhile to develop a working relation between the CCI and the anti-dumping authority. The anti-dumping authority could be asked to seek CCI's views before taking a decision on a matter. And CCI could give its opinion under the advocacy provisions of the Competition Act. This has also been echoed in the report of the High Level Committee on Competition Policy and Law, which recommended, "Anti-dumping measures need to be reckoned in the Competition Policy/Law with a view to dealing with anti-competition practices".
- Even if an FTA is unlikely to include mandatory changes in India's competition laws, the signing of an agreement with the EU could provide an opportunity for India to examine some of its rules and procedures, including the relationship between its competition policy and trade policy..

## 4.8.3. Possible Benefits and Costs

A brief analysis of benefits and costs are given below.

### Benefits

- Several international anti-competitive practices (e.g. cartels) had an impact on the relevant market in India, but the MRTP Commission (the outgoing competition authority) failed to take any action, resulting in huge losses to consumers, business and the economy. An effective cooperation and information exchange arrangement would help the CCI (the new competition authority) in taking appropriate action against enterprises engaged in anti-competitive practices with an impact on India.
- An effective competition regime and the cooperation arrangement could be useful in tackling abuse of dominance and other anti-competitive behaviour exercised by incumbent firms.
- Tackling restrictive business practices could be one of the issues to be addressed.

### Costs

- Developing country competition authorities, including India, do not have the resources or the experience to tackle international competition challenges.

This calls for substantial capacity building efforts, which would require significant resources.

- Given its capabilities and resources, Indian competition authorities may not be able to respond to the demands of the EU competition authority on information and other requirements. Moreover, as the Indian competition authority will be duty-bound to cooperate with the EU authority, this might lead to devoting a disproportionately larger proportion of its resources to cooperating with the EU, adversely affecting its own enforcement activities.
- The capacity of CCI and other government agencies needs to be augmented in order to deal with the issue of predatory pricing and anti-dumping in an appropriate manner.