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Trade Policy Review Body

TRADE POLICY REVIEW

INDIA

Report by the Secretariat

This report, prepared for the third Trade Policy Review of India, has been drawn up by the WTO Secretariat on its own responsibility. The Secretariat has, as required by the Agreement establishing the Trade Policy Review Mechanism (Annex 3 of the Marrakesh Agreement Establishing the World Trade Organization), sought clarification from the Government of India on its trade policies and practices.

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SUMMARY OBSERVATIONS

(1) ECONOMIC ENVIRONMENT

1. The Indian economy has grown rapidly over the past decade, with real GDP growth averaging some 6% annually. Despite external shocks, such as the Asian economic crisis and fluctuations in petroleum prices, which resulted in a slowdown to 4.8% in 1997/98, the economy recovered to grow at over 6% during the two subsequent years. Social indicators, such as poverty and infant mortality have also improved during the last ten years. Higher growth during this period is, in part, due to continued structural reform, including trade liberalization, leading to efficiency gains. In order to achieve further significant reductions in poverty, India is currently targeting higher real GDP growth of between 7% and 9% (compared with 5.4% expected for 2001/02); to meet this goal it will be important, as stressed by the authorities, to continue, and even accelerate, the reform process and increase competition in the economy.

2. Recognizing the important linkages between trade and economic growth, the Government has simplified the tariff, eliminated quantitative restrictions on imports, and reduced export restrictions. It plans to further simplify and reduce the tariff. To help counteract the anti-export bias, inherent in import and other constraints, export promotion measures have gained in importance. The Government has recently announced a further increase in these measures and pledged to reduce export restrictions. The policy has also suggested the creation and strengthening of enclaves such as export processing and special economic zones, which would "immunize" exporters from the constraints affecting the rest of the economy, such as infrastructure and administrative problems. The Government estimates that annual export growth of almost 12% is required in order to raise India's share of world trade from its present level of 0.67% to a target of 1% by 2007.

3. The authorities are firm in their view that improving the economic growth rate requires further structural reform. As restrictions on trade and competition have been reduced, constraints associated with infrastructure and regulatory bottlenecks have become increasingly evident. Investment also appears to have been deterred by high real rates of interest, which are in part due to government borrowing to finance its fiscal deficit, which remains high. The Central Government deficit has risen from 4.2% in 1995/96 to some 5.7% in 2001/02. This is compounded by the states' fiscal deficits; it is estimated that the combined central and state fiscal deficit was over 10% of GDP in 2000/01.

4. In order to redress the fiscal imbalance, steps are being taken to rein in expenditure and to improve tax collection. One recent measure is the introduction in Parliament of the Fiscal Responsibility and Budget Management (FRBM) Bill; the Bill aims to reduce the deficit by at least 0.5% per year with a view to reaching a deficit of not more than 2% of GDP by 2005/2006. Expenditure reductions are also being pursued, notably through reform of the food subsidy (public distribution system) and administered prices for petroleum. Steps are also being taken to reduce government stakes in state-owned enterprises, which remain a drain on government resources and a cause of inefficiency. To improve the revenue base, attempts are being made to reform the internal tax system. However, these attempts have met with limited success, especially with respect to state taxes. Moreover, with customs revenue still a relatively high share of fiscal receipts, further planned reductions in tariffs will probably require reform of the tax system.

(2) TRADE AND INVESTMENT POLICY FRAMEWORK

5. There have been no major changes in India's trade and investment policy formulation since its previous Review in 1998. Trade policies are formulated and implemented by the Ministry of Commerce and

Industry in consultation with other relevant ministries. In this, it is assisted by several autonomous bodies based in the Ministry as well as through regular consultations with trade and industry groups. Advice is also solicited from other government bodies such as the Prime Minister's Council on Trade and Industry and the ostensibly autonomous Tariff Commission, based in the Department of Industrial Policy and Promotion (Ministry of Commerce and Industry), as well as independent ad hoc groups appointed by the Government from time to time. In addition, the Planning Commission, in preparing goals for India's Five Year Plans, sets up task forces to examine trade and related policies.

6. India provides at least MFN treatment to all WTO Members. It has been a strong advocate of multilateral, rather than regional, trade initiatives and is party to few regional trading agreements. Efforts are nevertheless being made to strengthen regional agreements to which it is party, such as the South Asian Association for Regional Cooperation (SAARC) and the Bangkok Agreement. Under the South Asian Preferential Trade Agreement (SAPTA), the members of the SAARC have completed three rounds of trade negotiations and expect to complete the SAPTA in 2002. In addition, India maintains bilateral trade agreements with several of its neighbours, including Bangladesh and Nepal; under a free-trade agreement with Sri Lanka, in effect since 1 March 2000, India grants duty-free access for over 1,000 tariff lines and a 50% margin of preference for the rest of the tariff, except for a negative list. Negotiations to conclude bilateral trade agreements with several other trading partners are presently under way.

7. India's foreign direct investment (FDI) policy has been liberalized since its previous Review. Investment is not only allowed in a greater number of sectors, but a larger number of sectors than before are eligible for automatic investment procedures, involving registration with the Reserve Bank; permission from the Government is still required for investment in some sectors, while foreign investment is not permitted in a few sensitive sectors. Despite liberalization, India's record in attracting investment remains disappointing, with FDI accounting for some 1% of GDP; and there appears to be no significant improvement in FDI inflows since the last Review, suggesting perhaps that the policy and infrastructural environment are still constraints.

(3) TRADE AND TRADE-RELATED REFORMS

8. Since the previous Trade Policy Review of India, trade and related reforms have been pursued although more gradually than during the early 1990s. However, a major change since the early 1990s appears to be the acceptance of the need for continued reforms in order to raise economic growth and reduce poverty. In this context, barriers to trade have been reduced and internal structural reform has been pursued.

9. A major development since the previous Review was the removal of all import restrictions maintained for balance-of-payments reasons. As a result, the customs tariff has become the main form of border protection. There have been significant recent efforts to rationalize the tariff, but with numerous exemptions based on end-use, it remains complex. Tariffs are relatively high, but the average applied MFN rate fell from 35.3% to 32.3% between 1997/98 and 2001/02 and is expected to fall further, to 29% in 2002/03, as the "peak" rate of tariff is reduced from 35% to 30%. The tariff shows substantial escalation in some sectors, especially for paper and printing, textiles and clothing, and food, beverages and tobacco. The Government announced recently that it intends to simplify and lower the tariff to two tiers by 2004/05; 10% for raw materials, intermediates and components, and 20% for final products. In addition to the tariff, importers must pay additional and special duties on a number of products.

10. As a result of additional bindings taken by India in the WTO, the share of tariff *lines that are bound has increased since the previous Review, from 67% to 72%; new bindings were made primarily in textiles and clothing; India also renegotiated bindings in some agricultural items. The average (final) bound rate is 50.6%, higher than the applied MFN rate; this gap provided ample scope for applied rates to be raised recently on a few agricultural products.*

11. While import licensing and tariff restrictions are generally declining, there appears to have been an increase in other import measures. India has become one of the major users of anti-dumping measures, with some 250 cases initiated since 1995. Certain imports, such as automobiles and natural rubber, may enter only through specified ports. Similar restrictions relating to entry through certain ports have been removed on 300 sensitive items previously subject to import restrictions; imports of these products continue to be monitored.

12. As part of its policy to encourage exports, the Government is planning to confine export restrictions to a few sensitive items, as announced by the Export and Import Policy 2002-2007. Export and import prohibitions are maintained mainly for health and security reasons.

(4) OTHER MEASURES AFFECTING TRADE

13. Internal reforms have concentrated on improving efficiency and competition in the economy. Thus, while industrial policy remains important, its scope seems to have been reduced significantly. Compulsory licensing now appears to be required mainly for environmental, safety, and strategic reasons. In addition, since the previous Review, the number of activities reserved for the public sector has been reduced from six to three and the number of sectors reserved for the small-scale industry has been reduced from 821 to 799; another 50 items are expected to be removed from the list of items reserved for the small-scale sector. Price controls are maintained on several products, including fertilizers, petroleum products, and some agricultural products; some of these, including on petroleum and fertilizers, are gradually being phased out.

14. The need for increased competition is being addressed by gradually reducing the degree of direct government involvement in economic activities, including through a programme to privatize state-owned companies. State-owned companies, which were used to implement industrial and development goals, are a drain on government resources. Attempts have been made since the early 1990s to restructure those that are loss-making and, in some instances, to privatize them, although, until recently, the privatization programme has met with limited success; annual targets are not often met. The Government has redefined its privatization strategy recently and is willing to privatize all non-strategic companies; in strategic companies, including those involved in the arms and ammunition, defence, atomic energy and railway transport sectors, the Government will reduce its equity to 26%, or lower in some cases.

15. Efforts are also under way to modernize India's laws dealing with competition and industrial "sickness", while new measures have been taken to strengthen corporate governance. A new Competition Bill, which would replace the current Monopolies and Restrictive Trade Practices (MRTP) Act, is currently being examined in Parliament. The Bill aims, inter alia, to check the abuse of dominant positions and establish procedures dealing with mergers and acquisitions. When enacted, the Bill will also establish a new Competition Commission. Amendments were also made in 1999 and 2000 to the Companies Act, to improve corporate governance.

16. In view of the need to curb the fiscal deficit, tax reforms are being pursued. Complexities in the excise tariff structure have gradually been reduced, with a view to moving to a standard rate of 16% and ultimately to a value-added tax system. However, attempts to convert the state sales tax into a value-added *tax have had less success; this has been postponed twice since the original deadline of 1 April 2001. Efforts are also being made to reduce explicit subsidies, which account for some 1.2% of GDP in 2001/02 (explicit and implicit subsidies, however, are likely to be considerably higher, estimated at some 14.5% of GDP at the time of the previous Review of India).*

17. Since its previous Review, India has introduced amending laws on intellectual property rights, including for trade marks, and industrial designs; legislation to amend the Patents Act and on Biological Diversity is currently in Parliament. Steps are being taken to educate the public on the importance of compliance with intellectual property rights laws, although enforcement seems relatively weak.

(5) SECTORAL POLICIES

(a) Agriculture and allied industries

18. Policy in the agriculture sector has been guided by domestic supply and self-sufficiency considerations. Thus, the sector is shielded through import and export controls, including tariffs, state trading, export restrictions and, until recently, import restrictions. With the removal of import restrictions, tariffs on several agricultural products have been raised; as a result, the overall average MFN tariff for agriculture has risen from 35% in 1997/98 to 41% in 2001/02, but is expected to fall to around 37.5% in 2002/03 with the passage of the Budget for 2002/03. To encourage exports of agricultural products, the Government has set up agricultural export processing zones.

19. Internally, despite some recent reforms, the sector remains subject to a wide range of price and distribution controls. Price controls are maintained for staples to ensure remunerative prices for farmers. The Government also procures and subsidizes the sale of certain commodities through the public distribution system (PDS), which is targeted at low-income families. The products currently supplied through the PDS include wheat, rice, sugar, and edible oils. Over the years the PDS has become more targeted, while procurement by Government agencies has continued to increase (in part due to a rise in minimum support prices). The result has been a substantial increase in stocks, which greatly exceed the levels considered necessary to ensure food security, and in the costs associated with maintaining these stocks. Short-term measures, such as selling excess grain below economic cost, have been undertaken, but longer-term policy changes would seem necessary.

(b) Manufacturing

20. In manufacturing, which is dominated by textiles and clothing, there has been a decline in the use of industrial policy, including industrial licensing and small-scale-sector reservations. In addition, the removal of import restrictions in 2001 has further opened the market to international competition. Tariffs remain high, averaging 32.5% in 2001/02.

21. Textiles and clothing accounts for around 30% of India's total merchandise exports. Exports go mainly to the European Union and the United States, both of which maintain restrictions under the Agreement on Textiles and Clothing (ATC). In preparation for the removal of such restrictions, and to improve the sector's competitiveness, a number of measures have been taken recently. These include removal of some textiles and clothing products from the list of items reserved for the small-scale sector, and removal of foreign equity restrictions (with a small number of exceptions). The new Textile Policy also acknowledges the need to restructure, or close down, non-viable units, while ensuring adequate compensation for displaced workers.

(c) Services

22. Significant reforms have been pursued since the previous Review, especially in telecommunications, financial services and, to *some extent, in infrastructure services, such as power and transport. Liberalization in the telecommunications sector began in the early 1990s, with licences being issued to private investors for cellular telephone services. Since then, private investment has been allowed in all telecommunication services. The resulting increased competition from private service providers, as well as efforts by the regulator to rationalize tariffs and reduce cross-subsidization between local and international rates, has contributed to a significant improvement in India's telecommunications service network and to a reduction in tariffs.*

23. The reduction in telecommunication tariffs is likely to benefit the software sector, one of the major success stories in recent years. This success is in part due to India's abundant supply of relatively high-skilled and low-cost labour; compared with other sectors, software has also been relatively free of barriers to trade and investment. The Government does, however, provide support to the sector, including through tax and tariff exemptions, and software technology parks. Recognizing the linkages between software and telecommunications, the Government recently merged the Ministries of Information Technology and Communications and has introduced a new Communications Convergence Bill in Parliament.

24. The banking sector has been subject to gradual reform since the early 1990s. The most recent developments include measures to reduce the level of non-performing loans, especially in public-sector banks, and to restructure three public-sector banks. The Reserve Bank of India, which regulates the banking sector has also strengthened prudential requirements, including raising minimum capital and capital adequacy ratios. Supervision of banking and non-bank financial companies is based on both on-site and off-site monitoring on a regular basis. Key challenges continue to be the high level of non-performing loans and the restructuring of weaker public-sector banks. The insurance industry has recently been opened to competition from the private sector and new licences have been issued to private companies; foreign equity is restricted to 26% of the total. The role of the regulator, the Insurance Regulatory and Development Authority (IRDA), has been enhanced.

25. Infrastructure remains a major constraint on economic activity in India. Major shortages in the supply of electricity have resulted in the use of captive generation. The main suppliers of electricity, the state electricity boards (SEBs), have run losses, estimated in 2000 at around 1% of GDP, partly as a result of subsidized tariffs to the agriculture sector. Recent reforms have concentrated on addressing the issue of cross-subsidization of tariffs, through the establishment of regulators and reform of the SEBs; in addition, foreign investment restrictions in transmission were removed. In transportation services, the current Railway Budget has revised the tariff structure, reducing the cross-subsidy between freight and passenger transport; investment by the private sector has also been allowed. The private sector has also been encouraged to invest in the development and operation of national highways.

(6) OUTLOOK

26. India's economic reform programme resulted in strong economic growth throughout the 1990s despite external shocks. The recent slowdown, although partly due to the overall slowdown in the world economy, also demonstrates the necessity of continuing these reform efforts. In its recent annual Economic Survey, the Indian Government acknowledges the importance of "providing the right environment" for Indian industry to compete internationally and to raise annual real economic growth rates. The approach paper for the Tenth Five Year Plan (2002-2007) argues that the scope for efficiency improvement is large, but can only be realized if "policies are adopted which ensure such improvement".

27. While the process of dismantling some of India's complex system of trade and domestic controls has already yielded considerable results, there is a need for domestic structural reforms to be deepened and completed. In particular, difficult decisions are required to redress the fiscal imbalance, by reducing subsidies, completing the process of tariff and tax reform, and stepping-up privatization of state-owned enterprises. A reduced fiscal deficit is also likely to improve the investment climate and free resources for private and public investment, particularly in infrastructure services, which have become a major bottleneck to economic growth. Important steps have already been taken recently, including the introduction in Parliament of legislation on competition policy, changes in the Companies Act, and a decision to introduce changes in labour laws. Continued efforts to open the economy to international competition are likely to result in higher economic growth and a further rise in per capita incomes.