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Trade Policy Review Body

TRADE POLICY REVIEW

Report by the Secretariat

INDIA

Revision

This report, prepared for the fourth 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 India on its trade policies and practices.

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SUMMARY OBSERVATIONS

(1) ECONOMIC ENVIRONMENT

1. India's economic performance has been impressive, averaging over 7% between 2001/02 and 2006/07 (fiscal year, April-March). Growth has been particularly rapid since 2003/04, averaging over 8.5%, with over 9% expected for 2006/07. The Government is aiming to sustain growth at between 8% and 10% per year over the longer term. Rapid economic growth has translated into an improvement in social indicators, including a decline in infant mortality, a reduction in the percentage of the population living below the poverty line and improvements in literacy, sanitation and access to clean water. This impressive performance is largely due to unilateral trade and structural reforms, which have been continued during the period. Growth has been led by the services sector, where liberalization has been most rapid. Manufacturing has also performed well, although further growth may be impeded by infrastructure and other constraints. In contrast, agricultural growth continues to be slow and erratic and dependent on the weather, causing considerable distress, especially among small and marginal farmers.

2. Recognizing the importance of continuing its economic reform and especially its trade aspects, India has pushed ahead with further reductions in the tariff: the overall applied MFN rate fell from 32.3% to 15.8% between 2001/02 and 2006/07. There has also been simplification of the tariff, although it remains complex. The Government is targeting higher export growth in order to sustain India's high levels of economic growth and has put in place a complex set of schemes to reduce the anti-export bias of the trade regime for exporters.

3. Despite a gradual increase in total tax revenue since the previous Review, India's tax to GDP ratio is relatively low and seemingly insufficient to meet its developmental needs. Further public spending on infrastructure and social services is constrained by the Fiscal Responsibility and Budget Management (FRBM) Act, 2003, which requires India to reduce its fiscal and revenue deficits and to eliminate the revenue deficit by 31 March 2009. Private investment is also deterred by high real rates of interest, while foreign direct investment (FDI) at around 1% of GDP has remained disappointing. In order to meet its FRBM targets, the Government has introduced tax reform to improve collection and increase revenue. Expenditure reductions include further reform of the targeted public distribution system (TPDS) and a partial dismantling of administered pricing for petroleum. However, state-owned enterprises remain a considerable demand on government resources and the recent decision to "pause" privatization will have implications for future government support for these enterprises.

(2) TRADE AND INVESTMENT POLICY FRAMEWORK

4. There have been no major changes to India's policy framework since its previous Review. India has a Parliamentary system. The Lower House is elected directly and sits for five years, while the Council of States includes representatives elected by the legislative assemblies of the states. Executive power is vested in the President who appoints the Prime Minister and other members of the Cabinet. The Cabinet must be composed of Members of Parliament.

5. India's legal system is based on written law. The judiciary is headed by the Supreme Court, which has jurisdiction over all disputes between the Central Government and states or between the states. The Supreme Court is also the court of final appeal for cases heard by the High Court in each state, and by district and session courts at the local level. The legal system is burdened by insufficient resources and procedural delays, resulting in a large and apparently growing backlog of cases before the high courts and the lower courts. Measures are being taken to address the backlog of cases, including *through the establishment of fast-track courts and greater funding to the judicial system.*

6. While trade policy making and implementation is the responsibility of the Central Government, through the Department of Commerce in the Ministry of Commerce and Industry, the Constitution gives exclusive or overlapping jurisdiction on a number of related areas to the states. This requires continuous interaction between the Central and state governments and in some cases, such as changes in the structure of indirect taxation and electricity tariffs and provision, has led to delays in reform. The Government also consults with other stakeholders when formulating trade policy, in several cases through a period of public comment for new legislation or policy documents.

7. Trade policy is articulated for a five-year period, with annual updates, through the Foreign Trade Policy. While the Foreign Trade Policy calls for a simplification of import procedures and reduction of import barriers, a major goal is to increase exports and use trade to generate employment. Export growth is to be facilitated through a range of schemes to "neutralize" duty on imported inputs used in exports; such schemes contribute to the complexity of India's trade regime. Measures to attract foreign investment have also been taken, including by increasing the number of sectors in which FDI is permitted and reducing sectoral restrictions.

8. While extending at least MFN treatment to all its trading partners, India has also signed a number of regional trade agreements (RTAs) to increase market access for its exports. Thus far, RTAs have been signed only with other developing countries, but India is also examining the possibility of signing economic cooperation agreements with some developed countries. Since its previous Review, India has signed an RTA with Singapore, an "early harvest" arrangement with Thailand and a preferential agreement with Afghanistan. In addition, previous arrangements, including the Asia Pacific Trade Agreement (APTA), the South Asia Free Trade Area and the Bay of Bengal Initiative for Multisectoral, Technical and Economic Cooperation, have been amended or have come into force.

9. Foreign investment policy continues to be liberalized. Besides the measures noted above, efforts have also been made to streamline the approval and investment process, which was identified in a government report as a possible barrier to investment. Nevertheless, FDI remains far below its potential, at around 1% of GDP, suggesting that policy and infrastructural constraints need to be addressed.

(3) TRADE AND TRADE-RELATED REFORMS

10. Import duties are among India's main trade instruments as well as an important source of tax revenues, accounting for around 17.5% of Central Government tax revenue. Applied MFN tariffs, especially for non-agricultural products, have continued to fall steadily, with the overall average currently at 15.8%. At 12.1% (14.1% including ad valorem equivalents), the average for non-agricultural products is considerably lower than the average for agricultural products, which is 40.8%. The growing gap between agricultural and non-agricultural tariffs has also raised dispersion in the tariff and the escalation pattern shows increasing de-escalation between unprocessed and semi-processed and in some cases between semi-processed and final products. With the exception of a few applied tariffs, which are at their corresponding bound rates, the difference between the bound and applied tariff rates is considerable. This difference gives the Government considerable scope to raise applied tariffs, scope that was used to raise tariffs for some agricultural products in recent years. Nonetheless, the overall trend in tariff rates continues to be downward; in its 2007/08 Budget, the Government announced a further reduction of the "peak rate" from 12.5% to 10%. Despite gradual reform over *the years, the tariff remains complex: tariff changes are announced throughout the year and with numerous exemptions, a number of which are based on industrial use. The policy regarding tariff rate quotas remains unchanged since the previous Review.*

11. India also offers tariff preferences under its regional trade agreements. However, apart from the agreement with Sri Lanka and preferences to LDC members of SAFTA, the preferences do not appear to be significant. The use of import restrictions has declined, with around 3.5% of tariff lines subject to such measures. Another 300 sensitive imports are monitored, while the policy with regard to state trading remains essentially unchanged since the previous Review.

12. India continues to be a major user of anti-dumping measures, although the number of investigations and measures in force have been in decline. The majority of initiations were targeted at chemicals, plastics, and rubber products; base metals; and textiles and clothing, and were aimed mainly at China, the EC, Chinese Taipei, and Korea. Safeguard measures were taken against one product, in addition to one taken specifically against products from China; no countervailing measures were taken during the review period. Steps are being taken to align national standards increasingly with international norms; currently, some 73% of national standards for which corresponding international standards exist, are aligned with these international norms. In general, national standards are subject to review every five years to ensure that they keep up with international trends. SPS procedures are also being streamlined, notably with the passage of the Food Safety and Standards Act in 2006 to consolidate 13 separate laws relating to SPS issues; in addition, a risk analysis process has been put in place since 2004. India is not a member of the WTO Agreement on Government Procurement. Its procurement policies have undergone reform, especially at the Central Government level, although preferences continue to be extended to certain items from the small-scale industry and from state-owned enterprises.

13. While import barriers have been falling, India's export regime continues to be complex. Export prohibitions and restrictions are largely unchanged since India's last Review. However, in order to reduce the anti-export bias inherent in India's import and indirect tax regime, a number of duty remission and exemption schemes are in place to facilitate exports. While a number of these schemes are open to all exporters who use imported inputs, several schemes are targeted at sectors such as electronics (hardware and software), agricultural products and services. Export processing zones, export-oriented units (which are now special economic zones (SEZs)) also offer tax holidays to investors. According to Ministry of Finance estimates, revenue forgone from such schemes was Rs 538 billion in 2006/07, with an additional Rs 21 billion estimated for the SEZs. The cost effectiveness of the schemes in generating incremental investment and employment is open to question. As many of the industries attracted, especially by the SEZs, appear to be capital intensive, it is not clear that this is the most effective way to create employment opportunities, especially for the less-skilled labour force. India also provides export assistance through export insurance and financing schemes by the Export-Import Bank of India.

(4) Other Measures Affecting Trade

14. Along with trade policy reforms, internal reforms have concentrated on increasing competition and efficiency in the economy. Industrial policy reforms have concentrated on simplifying and reducing restrictions. Thus, the number of industries requiring compulsory industrial licensing for safety, environmental, and strategic reasons has been reduced from six to five, while the number of items reserved for production only by the small-scale sector has declined further, from 799 in 2001 to 326 in May 2006. The *number of industries reserved for the public sector is unchanged.*

15. Measures have been taken to simplify the tax structure, especially for indirect taxes, resulting in a substantial increase in revenue collection. Tax reforms have also been pursued to meet the fiscal deficit targets set by the FRBMA and include the introduction of a new value-added tax and an increase in the number of services subject to a service tax. The introduction of the VAT by all but one state opens the way for an eventual goods and services tax. India maintains an "excise" tax (CENVAT), which is a tax on manufacturing, but appears to have elements of a value-added tax as well: currently providing around 25% of Central Government tax revenue, the CENVAT remains the largest source of indirect tax revenue. In the longer run, further streamlining of India's various indirect taxes are planned so that the VAT, the CENVAT, and the services tax will be replaced by a broad-based goods and services tax.

16. Less progress has been made on reducing direct and indirect assistance to various sectors of the economy. Direct subsidies, it is estimated, accounted for around 1.4% of GDP in 2005/06, although a recent study for the Ministry of Finance suggested that explicit and implicit subsidies accounted for around 4.2% of GDP in 2003/04. The study also suggested that "merit" subsidies, including for education, health care, and research and development, were about 42% of this total. Most central government subsidies are destined for food, while other key subsidies include those for petroleum and fertilizer. The states also provide additional subsidies, especially for basic services such as education and health. Another element of subsidy is contained in price controls, which are basically unchanged since the previous Review, although the removal of the administered price mechanism has reduced the subsidy provided for petroleum products. Current price controls include minimum support prices for 25 major crops, fertilizers, and 74 bulk drugs and related formulations that remain controlled under the Drugs Price Control Order, 1995. Price controls also exist under the targeted public distribution system. In addition, the prices of certain services, such as electricity and water, may be fixed by state governments.

17. Efforts to increase competition have been aided by the introduction of new legislation to encourage competition and to ease the closure of unviable companies. This includes the passage of a new Competition Law, and a Micro, Small and Medium Enterprises Act, passed in 2006 to encourage the development of these businesses. To tackle the problem of "industrial sickness" especially in the public sector, a Bill, introduced in Parliament in 2003, was passed but not yet implemented due to delays in setting up a National Company Law Tribunal to replace the Board for Industrial and Financial Restructuring (BIFR). Progress has been made in improving corporate governance, notably through improved listing requirements for listed companies and banks; in addition, efforts are under way to amend the Companies Act, 1956, to increase transparency and accountability.

18. Public sector reform, on the other hand, has been delayed by a decision in July 2006 to keep all decisions on disinvestment in state-owned enterprises on hold pending a review; consequently, the privatization programme has effectively stopped. The policy of the current Government before this decision was to list large profitable SOEs on domestic stock exchanges, while retaining a majority shareholding.

19. The main changes in protection of intellectual property rights include the passage of new legislation on patents, aimed at bringing Indian legislation in line with the TRIPS Agreement, and the establishment of a new Geographical Indications Registry in 2003. Steps are also continuing to improve enforcement of intellectual property rights including through increased seizures of *infringing materials, and fines, although apart from copyright infringement, there are few data available on enforcement.*

(5) SECTORAL POLICIES

(i) Agriculture

20. The share of agriculture and allied activities in India's GDP continued to decline during the period under review, from some 23% in 2000/01 to 18% in 2005/06. However, the sector employs around 60% of the working population, suggesting that labour productivity is only around one-sixth of its level in the rest of the economy. Low productivity is due in part to fragmented landholdings, low mechanization levels, and dependence on rainfall, but also because public investment in infrastructure and research has been inadequate due to crowding out by spending on direct and indirect subsidies to the sector. Food security remains a major concern and a cause for much of the continued government intervention in the sector. This includes minimum support prices for 25 essential commodities, minimum intervention prices for other crops, subsidies for inputs, such as fertilizers, water, electricity, and seeds, and high import tariffs, averaging 40.8%. The Government also ensures distribution of certain foods at subsidized prices to poorer households through the "targeted public distribution system".

(ii) Manufacturing

21. In 2005/06, manufacturing accounted for 16% of GDP. Its share has remained at 15% to 16% since 2000/01. Growth in the sector has been rapid, on average almost 7% per year since 2000/01; this can be attributed, in part, to continued structural reforms and a relaxation in licensing and FDI restrictions. The sector, however, continues to be protected by relatively high tariff barriers, especially in textiles and clothing (22.5%, including AVEs), and automobiles (33.6%). In addition, imports of second-hand motor vehicles are subject to licensing requirements. Further growth in manufacturing is hampered also by a lack of infrastructure and labour market rigidities.

(iii) Services

22. Services have been the main engine of growth in recent years. Average annual growth over the last four years has been 9.8%, largely due to greater progress in reform, especially for certain services. Reforms in banking include further relaxation of foreign investment limits and steps to align prudential requirements with international practice. Measures have also been adopted to improve governance in banks and to prepare the sector for implementing the Basel II capital adequacy framework. As a result, there has been a decline in the ratio of non-performing loans (NPLs) for most segments, although rural banks and rural cooperatives continue to suffer from high exposure to NPLs. Efforts to create a well-functioning capital market are being pursued by the Securities and Exchange Board of India, the regulator of the securities market.

23. Infrastructure remains a major bottleneck. In sectors such as telecommunications, where the market has been exposed to competition, there have been significant benefits to consumers, including through increased penetration, especially of mobile telephony, and a decline in tariffs. Progress has also been made in improving the transport infrastructure, especially road transport, where the network of national highways is being expanded. Although rail transport is one of three activities reserved for the public sector, private-public partnerships are being encouraged in some areas, for example, such as freight transport and railway infrastructure development. Liberalization has also taken place in air transport, resulting in an expansion in the number of airline operators and a decline in prices; foreign investment restrictions have also been relaxed (up to 49% of total equity is permitted), although foreign airlines are forbidden from investing in the sector. In contrast, maritime transport and port services continue to suffer from inefficiencies and constitute a major *impediment to trade. Another major constraint on economic activity is the energy sector, where there are frequent shortages of supply and little progress appears to have been made in tackling the losses of state electricity boards, and transmission and distribution losses.*

(6) PROSPECTS

24. India's high rates of economic growth in recent years are the result of significant structural reform including trade liberalization. If this fast growth is to be sustained, however, further reform will be required.

25. Such reform would need to address, inter alia, infrastructure bottlenecks, which continue to constrain growth. In particular, urgent attention is required for transport, and especially electricity, where supply continues to be deficient and loss-making public sector suppliers remain a drain on public finances. Deeper reforms are also required in agriculture, where, despite increased public sector spending in recent years and reduced controls on agricultural markets, further efforts are needed to address the sector's relatively low productivity and the problems of marginal farmers, reflected in social indicators, such as poverty and infant mortality.

26. Structural reforms will need to be accompanied by appropriate macroeconomic policies, i.e. a monetary policy that contains inflationary pressures and fiscal policies that ensure that the public finances are sufficient to meet India's developmental needs. As regards the latter, India's fiscal deficit, while declining, remains significant, and public expenditure on infrastructure and human capital development is constrained by the relatively low level of taxes to GDP as well as by spending on subsidies.

27. Continued structural reform, together with greater investment in physical and human capital would assist in generating productive employment for new entrants to the labour force. This would help India to reap the "demographic dividend", with one third of its population currently below the age of 18.