Centre for the Analysis of Regional Integration at Sussex

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

Executive Summary

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1. Key Findings

The central findings of this report are that the gains from an EU-India FTA depend greatly on the extent to which such an FTA adequately identifies and deals with issues of deeper integration in areas such as government procurement, services, investment, trade facilitation, trade defence, standards, intellectual property and competition policy. If an agreement is largely confined to issues of shallow integration – notably the reduction of tariffs – then we conclude that there is a strong possibility of trade diversion exceeding trade creation for both parties, and therefore a low probability of a shallow integration induced welfare gain. The gains from deep integration are potentially much higher as these can lead to trade induced productivity improvements driven by technological changes, spillovers between firms, niche specialisation and economies of scale. In order to realise these gains, there is a need for agreement and/or action on a range of issues identified in this report. Finally, it is of course important to highlight that the likely impact of an EU-India FTA will in turn depend on whether there is a successful conclusion of the Doha Development Round at the WTO, and on the nature of any agreement arrived at therein.

2. Background

For more than half a century economists have understood that preferential, as opposed to non-discriminatory, liberalisation of international trade and cross border investment entails both costs and benefits for the countries concerned. The balance of these costs and benefits are not a given and it requires careful analysis to attempt to draw a balance and to ask what would need to be included or excluded from any agreement to ensure benefits to one or both sides.

The size of this report (over 300 pages including detailed annexes) is evidence of the amount of detailed analysis that is potentially necessary to pinpoint key issues and suggest where the balance of advantage might lie - and what might need to be included in any EU-India FTA to deliver a positive outcome.

This Executive Summary will indicate the shape of the report, but rather than summarise it section by section, it will outline the likely benefits for each party, the likely costs and the measures that might need to be included to increase the likelihood of net benefits.

3. The Shape of the Report

The main report, amounting to about 70 pages, provides a summary of the detailed analysis that was undertaken as part of this study. In the main report we identify the key issues which emerged in undertaking this study. Those key issues deal with the potential consequences of an FTA both with respect to shallow integration, and with respect to deep integration[1], the perceived obstacles to trade and integration between the EU and India, and the central implementation issues which are likely to arise. The main report is accompanied by four annexes that provide the following detailed analyses:

> **Annex 1** draws on the Sussex Framework for analysing preferential trade agreements in assessing trade and production structures and their implications for shallow and deep integration resulting from an FTA
>
> **Annex 2** considers 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. The latter is achieved via the estimation of a gravity model of the impact of the formation of preferential trading arrangements on bilateral FDI, and then applying the results to an EU-India FTA.
>
> **Annex 3** deals in detail with the regulatory structures, regulatory objectives and implications for trade in the areas of government procurement, services, investment, trade facilitation, trade defence, standards, intellectual property rights, and competition policy.
>
> **Annex 4** builds directly on the analysis in Annex 3 and considers the likely implementation issues in India arising from an India-EU FTA. As with Annex 3,

[1] **Shallow integration** involves the removal of border barriers to trade, typically tariffs and quotas. **Deep 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 policy protection and the rules surrounding access to government procurement.

this part of the report evaluates these for government procurement, services, investment, trade facilitation, trade defence, standards, intellectual property rights, and competition policy.

4. Potential Benefits of an EU-India FTA

4.1. Relatively easy to negotiate

1. There appears to be comparatively little sectoral overlap on trade structures or measures of revealed comparative advantage on goods between the EU and India. This would suggest that the two parties have somewhat different offensive and defensive interests which in principal should make negotiation of an agreement easier.

2. The share of India in the trade of the EU is low (around 1.5% for both imports and exports), and therefore liberalisation with India is unlikely to be perceived as a major threat. The share of the EU in India is higher (share of imports = 25%; share of exports = 21%. However, India's trade is becoming substantially and increasingly diversified by geographical source over time, and the share of the EU has significantly declined since the early 1990s. We therefore also conclude that liberalisation with the EU is in general unlikely to be perceived as a major threat, though there may be specific sectors where particular issues arise.

3. Services is the fastest growing part of the Indian economy and India has offensive interests in GATS mode 1 (call centres, down the line software engineering) and mode 4 (business visas, software engineers, accountants, lawyers in both directions) liberalisation. Both parties are therefore interested in including services in a FTA agreement.

4. It would also appear from discussions with relevant officials that agricultural liberalisation is unlikely to be a major demand from either party in an FTA and that exclusion of sensitive products on either side is likely to be manageable within the substantially all trade criterion of the WTO.

4.2. Potential for 30% increase in each way flows of bilateral FDI as a direct result of signing an FTA

5. In recent years the attractiveness of India as a destination market for foreign direct investment has substantially increased and this has been reflected in an increase in FDI inflows. However, available evidence also suggests that there are a number of structural impediments in India which result in implemented levels of FDI being much smaller than the approved levels. Those impediments relate to procedural issues, labour laws, levels of corruption and overlapping jurisdictions between states and central government and so on. Improvements with regard to these impediments are likely to significantly increase the attractiveness of India for foreign direct investment.

6. Investment caps in a number of sectors suggest potential for national treatment or higher caps for EU firms.

7. Our formal gravity modelling suggests a positive relationship between the formation of regional trade agreements and foreign direct investment. Our estimated coefficients suggest that an EU-India FTA is likely to increase FDI flows from the EU by 27%, and FDI stocks by 18%.

4.3. Potential for economic gains for both sides from deep integration

8. The growth in FDI is closely linked to the potential for gains arising from deeper integration between the EU and India (see above). Increased FDI is, for example, likely to foster faster technical change and total factor productivity growth, exploitation of scale economies arising from increased specialisation, and/or may help to generate positive externalities between firms and/or sectors.

9. India has a high and fast-growing share of trade in vertically integrated intra-industry trade (IIT) suggesting it is integrating into global supply chains and specialising in a productivity enhancing way. The gains arising from such vertical specialisation are also likely to be higher to the extent that an EU-India FTA promotes deep as well as shallow integration.

10. The growth of FDI and the growth of vertically integrated trade suggest that there is a clear case for discussing regulatory approximation between the partners to further enhance the gains from deeper integration.

11. 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 possibly more rapid liberalisation of India's services than can be accomplished unilaterally or multilaterally. The challenge for the FTA is not only to accelerate liberalisation in India's services sectors, but also to facilitate the implementation of a range of complementary reforms designed to improve the quality of regulation. An important objective for an EU-India FTA would thus 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.

12. Trade facilitation is a key issue. There are clear problems in India relating to transparency, different implementation/enforcement policies, complex procedures for calculating customs duties, delays in customs clearance and inter-state variations in internal transit procedures. To the extent that these issues can be successfully resolved or improved upon, the gains from bilateral integration are likely to be that much higher.

13. Government procurement issues are likely to be important for the EU. 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. There is clear potential for gain for both parties by redressing these difficulties.

4.4. Potential for Regulatory Convergence

14. Indian standards are not always consistent with international norms. Where they diverge from international norms, it appears that they do not have any obvious efficiency rationale, and therefore they may be set for protectionist reasons. An FTA could eventually help India converge to international norms if backed by mutual recognition of testing and certification. There are issues on both sides here, and while it would be a major challenge, it could be important in areas relevant to market led deep integration and in expanding bilateral intra-industry trade. FTAs rarely offer more than an expression of hope for mutual recognition but it would appear that the economic benefits might well be significant in areas where there is already a developing market.

15. An FTA with the EU, particularly including deep integration, could help India to bind domestic regulatory reforms and underpin MFN trade liberalisation.

5. Potential costs of an EU-India FTA

5.1. Trade diversion

16. India has average applied MFN tariffs on goods of 16% with very high tariff peaks (up to 160%) on a relatively small number of goods. This, coupled with the relatively small (25% excluding petroleum products) and declining EU market share (from over 40% in the early 1990s) and the low overlap in production structures between the EU and India, suggests that there is considerable scope for trade diversion for India. This would imply India increasing its imports from the EU but at the expense of more efficient suppliers from third countries.

17. For the EU, India's share in imports and exports is around 1.5% with some increase over the last decade. The low share of trade with the EU coupled with the low tariffs applied by the EU on Indian exports (though with a higher incidence of tariff peaks) suggest that there is little scope for trade creation, and again more likelihood of trade diversion.

18. Diversion away from more efficient third country suppliers may also apply in services trade and FDI if the FTA gave preferential regulatory regimes to the EU, such as the removal of investment caps in service sectors where other suppliers had begun to enter, but where there is negligible foreign entry to date, EU firms would expand supply to the benefit of consumers while perhaps at the expense of Indian firms i.e. create trade.

5.2. Structural and policy impediments in the Indian economy which may limit the gains from deep integration

19. In a range of areas such as government procurement, trade facilitation, investment etc. there are important difference between state and central government policies. Hence, even if agreement is achieved with the Central Government, the potential for gain is likely to be diminished by policies and procedures at the state level.

20. Transparency is a major problem across a range of issues which include investment, trade facilitation and government procurement, as well as SPS and TBT. This applies at both the central and state level, and clearly, a lack of transparency is also likely to limit gains from deep integration.

21. Foreign Direct Investment is partially regulated for service by GATS commitments, but these commitments are below those under autonomous liberalisation. State level regulations and procedural difficulties appear to inhibit FDI even where investment authorisation at the centre is automatic.

22. There are some concerns about the application and enforcement of Indian Competition law, and dealing with this in the context of a FTA is unlikely to be straightforward.

23. Evidence also suggests that there are significant non-tariff barriers to trade in India, which appear to be approximately of the same order of magnitude as the tariff barriers themselves. The continuation of such barriers will again lessen the potential gains derived from tariff liberalisation. It is worth pointing out however, that agreement on deep integration issues as identified earlier (such as trade facilitation or standards) is likely to reduce the height and incidence of the NTBs.

24. The divergence of Indian standards from global norms suggests embedded protectionism which may block benefits from an FTA. Large scale harmonisation and adoption of international standards across the Indian economy for all domestic producers would be a major challenge, not to mention costly in the medium term for producers and probably consumers. However, Indian exporters able to meet international norms would benefit from cooperation on conformity assessment, as would EU exporters to India.

5.3. Anti-dumping policy could undermine the benefits of a FTA

25. Anti-dumping has been a major tool of trade policy on both sides globally but also bilaterally. India and the EU have had a series of disputes at the WTO and though the number of anti-dumping cases has come down over time there are still concerns about the quality of investigations, an issue that could be addressed by the FTA.

6. Implementation issues and key areas for negotiation to maximise benefits and minimise costs

26. There is a need for both parties to identify those commodities for which trade diversion is most likely and to consider whether and how these products should be included in an agreement, and the role of MFN tariffs for these products.

27. Similarly there is a need for the careful identification of NTBs and then agreement on their removal.

28. This report argues that there is potential for substantial benefits from deeper integration across a range of issues. The gains from an FTA are likely to be significantly higher to the extent that there can either be formal agreement on the issues listed below, or to the extent that appropriate reforms are unilaterally undertaken by India with regard to these issues. Hence, gains will be higher where there is:

    a. Encouragement of intra-industry trade (IIT) through convergence of standards and mutual recognition of conformity testing and certification.
    b. Liberalisation of the FDI regime, including raising investment caps in some sectors and opening up closed sectors such as legal services or accountancy.
    c. Increased transparency in information and procedures with respect to investment rules and government procurement rules at both central and state level, with particular significance for the national treatment of EU investors.
    d. Improved national treatment for EU services providers in Modes 1 through 4; business visa regime; mutual recognition of qualifications in selected areas.
    e. Action taken to examine with the Indian government where state rules may impede trade and investment, and look for revisions.
    f. Identification and addressing of key obstacles to trade facilitation at both the central and the state level.
    g. Improvement with regard to the enforcement of the IPR regime in India.
    h. Improved enforcement of competition policy.