Chapter 5
The EU-India FTA Negotiations: A Closer Look at the Fundamentals from a European Perspective

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Introduction

EU and India first launched negotiations for an EU India Free Trade Agreement (FTA) in 2007. Since then, progress has been achieved in the areas of goods, tariffs, services, investment, procurement, standards and trade facilitation; but it might still take a while before negotiations are finally concluded. As negotiations have not only focused on trade, but also on facilitation of bilateral investments, the FTA is often referred to as a Bilateral Investment and Trade Agreement (BITA).

Strong complementarities between the economies of the EU and India – implying that many Indian export products are not produced in the EU and vice versa – widen the scope for mutual benefits from an FTA. Nevertheless, as negotiations proceed, it becomes clear that there are conflicting views and interests on specific issues. The fact that the FTA with the EU is the most ambitious one India has taken up so far, adds to the complexity of the agreement. In the past years, EU and Indian media have frequently announced the imminent conclusion of FTA talks; but time and again a new stumble block seems to arise and stall negotiations.

Some say that the EU-India negotiations have been dragging on for too long. In comparison, FTA negotiations with Korea were launched at the same time as those with India, and concluded in 2011. On the other hand, FTA negotiations with Mercosur (the Common Southern Market, an economic and political agreement

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This research has been conducted before Anneleen Vandeplas started working at the European Commission, with financial support of the Research Foundation Flanders (FWO). Opinions expressed in this paper are those of the author and do not reflect the view of her past or present institutions.

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S.O. Wolf et al. (eds.), *The Merits of Regional Cooperation*,
DOI 10.1007/978-3-319-02234-5_5,

between Argentina, Brazil, Paraguay and Uruguay), which were first launched in 1999, are still ongoing as well.

For the EU, the FTA talks with India can be considered in the context of its Global Europe Strategy, which was unveiled in 2006 and aims at broadening the scope of EU trade policy and adopting a more offensive stance in trade negotiations. The rise of new economic powers – including India – has encouraged the EU to proactively seek trade collaboration and increased market access, to benefit from growth in these emerging economies as domestic growth is slackening, and to maintain its position in the global economy. India is an attractive trade partner, with high growth rates (even if growth has come down recently), a rising middle-class, and booming domestic consumption.

For India, integration with the global economy is a relatively new phenomenon. India made its first move towards liberalization fairly recently, in the beginning of the 1990s. In contrast with China, its domestic growth is not based on exports; but rather led by domestic consumption growth. As a result, India is not overly concerned with trade deficits or with chasing trade surpluses, even at the level of services. India tends to be more concerned about the fact that many (poor) livelihoods are at stake; which restricts its flexibility in trade policy. With half of its population under the age of 25, it is imperative for India to pursue a strategy of job-creating growth. All these elements contribute to explaining why India is generally maintaining a defensive stance in trade negotiations, in contrast with other Asian economies pursuing a strategy of export-led growth, which are often taking the offensive in trade negotiations. Still, India is seeking integration not only with Western, but also with Eastern economies such as Japan, Korea, and the members of the Association of Southeast Asian Nations (ASEAN).

Why Free Trade?

The major argument used in economics to advocate for free trade is *efficiency*. All over the world, governments are trying to protect domestic producers of agricultural and industrial goods by imposing tariffs on imported goods. Tariffs increase the price of imported goods, and as such make domestically produced goods more attractive as compared to goods produced abroad. This increases the demand for domestic goods beyond what would be demanded in a fully liberalised world market; and reduces the demand for foreign goods. However, it also increases consumer prices of protected goods, at the expense of domestic consumers. If foreign producers are more efficient than domestic producers in the sense that they can produce at a lower cost, tariffs are protecting less efficient producers against competitive pressure from more efficient producers.

With free trade, tariffs are abolished and less efficient producers may be driven out of the market by more efficient producers. In some cases this may mean that a domestic sector is driven out of business by a foreign sector. Domestic producers who fear cheap imports from abroad therefor tend to lobby their government for protection through tariffs, quotas or other trade policy instruments.

A prominent example of a sector which serves as an important source of jobs and income is the automotive sector – and countries around the world (including China, India, the US and EU Member States) are using a range of instruments to support automotive sectors in their country to prevent job loss.

India has historically set very high tariffs on imported cars. While these tariffs have already come down from 100–200 % in the 1990s to 60–100 % in the 2000s, current tariff levels still imply that a consumer in India willing to buy a Germany-produced Mercedes has to pay approximately twice the price the German manufacturer will receive – and that Indian manufacturers of luxury cars will still be competitive if they produce at twice the cost of a German manufacturer. High tariffs may also convince manufacturers to set up factories in India itself, with positive impacts on local employment.

It is clear that Germany is a strong supporter of liberalizing trade in the automotive sector between the EU and India, as demand for German cars is expected to mount if consumer prices halve. Also Indian consumers gain from being able to buy foreign cars at reduced prices. Those domestic producers who are not able to compete against foreign producers, however, will lose out, and manufacturing jobs may be lost if domestic factories close down (or are not set up in the first place). Alternatively, however, increased competitive pressure may give domestic companies the necessary incentive to either increase their productivity, reduce inefficiencies in production and markets, and become more competitive. If domestic companies fail to increase efficiency in producing cars, there might be other ways to shift scarce resources (such as capital) into producing something Indian companies are more efficient in. Free markets can also foster efficiency gains through economies of scale, if production costs can be pushed down by operating at a larger scale.

The efficiency argument should be used with caution, nevertheless, as it is based on the assumption of perfect markets. If there are important domestic market failures, for example because labour cannot move out freely from less efficient to more efficient sectors, then there may be benefits from protecting an inefficient sector – at least temporarily – while policy makers focus on finding solutions to solve market failures. For example, if there are not sufficient jobs outside of agriculture for inefficient Indian farmers with low levels of education to move into, the Government of India may want to protect its agricultural sector to avoid massive impoverishment in rural areas. This argument has been used extensively by civil society actors advocating continued protection of the Indian dairy sector, as it is considered a 'pro-poor' sector, with many very poor and landless farm households being involved in dairy production.

However, it is not easy to determine in which cases protection is justified, and in which cases it is not. The difficulty of quantifying welfare effects of protection creates an opportunity for powerful interest groups to lobby for stronger, and unjustified protection, which leaves society worse off. This is often used as a political argument in favour of free trade: if markets are free, there is less scope for producer or trader organizations to seek unjustified protection and earn high profit margins at the expense of domestic consumers and foreign producers.

Bilateral Trade Integration

Under the aegis of the World Trade Organization (WTO) more than 150 member countries are negotiating multilateral agreements on the reduction of trade barriers with a view to fostering economic growth and development (based on the efficiency argument discussed above). The high number of partners involved in the negotiations and the complexity of decision procedures slow down the emergence of trade agreements considerably.

As a result, moves towards free trade lately tend to take the form of bilateral free trade agreements (FTAs) as these involve less negotiation partners and are therefore easier to negotiate than multilateral agreements. An FTA can aim for 'shallow' integration – merely focusing on removing barriers to trade by cutting back trade protection instruments such as tariffs and quotas, or be more ambitious and aim for 'deep' integration, which entails a transformation of policies and institutions in addition.

Shallow Integration

The reduction of tariffs and quotas may affect global welfare positively through trade creation. That is the case if production is shifted from less efficient to more efficient producers, and more welfare is being achieved with the same resources. However, shallow integration may as well lead to trade diversion, if trade within an FTA simply replaces trade with other countries which do not take part in the FTA – and production is shifted from more efficient to less efficient producers instead. Take for example the case of textiles in the EU. Where India and China currently face similar tariffs in the textile sector; China is considered as more efficient in producing clothes than India. If the EU removes tariffs only for India, Indian clothing products might become more attractive for EU consumers than Chinese clothing products – such that production might be shifted from more efficient to less efficient producers, reducing public welfare.

From a European perspective, tariff reductions and increased demand for EU export products is considered paramount to getting the EU out of its current economic slump. Industrial production is going down in the EU, and companies are massively turning to emerging markets abroad to find new sources of demand growth. The automotive sector is a case in point, where the EU suffers from overcapacity, or insufficient demand, and where many EU member states are strong supporters of improving export prospects to markets abroad.

Similar considerations are being made in South-Korea and Japan, who respectively have negotiated and are still negotiating tariff reductions in automobile trade with the EU. They are looking out to reap the benefits from increased access to European markets.

Other sectors where EU is requesting India to reduce tariffs include alcoholic beverages and dairy, where very high tariffs apply and constitute a major barrier to EU-India trade. Conversely, EU also imposes high tariffs on dairy products originating from India.

Integration does not always result in increased trade, however. The effects of shallow integration may be strongly mitigated by the existence of sanitary and phytosanitary measures (SPS) or technical barriers to trade (TBT), which are important barriers to trade between the EU and India. For example, even if the EU would remove its tariffs on dairy, it is unlikely that India would be able to export its milk to the EU in the short term. The EU imposes strict food quality and safety standards on imported milk products, specifying conditions for milk production (e.g. health conditions of dairy animals), procurement (e.g. a very short time frame within which milk must be cooled down after milking) and processing which India's current dairy production system cannot possibly comply with.

Likewise, India imposes SPS barriers upon its dairy trade partners. For example, India has banned Chinese dairy after the 2008 Chinese melamine milk scandal. Since then, the ban has been repeatedly extended; and it will remain in vigour at least up to June 2014. India has also imposed specific SPS requirements on imported milk originating from the US – virtually precluding milk imports from the US since 2003.

Similarly, specific technical product standards can be imposed on manufactured goods and hamper international trade in the absence of tariffs. Hence, cutting back tariffs and quotas alone does not always lead to increased trade.

Deep Integration

The EU-India talks have not remained restricted to trade facilitation. Instead, a more ambitious approach has been taken on, aiming at key reforms to encourage bilateral investment. As this involves increased bilateral mobility of capital and labour, but also strengthening regulations regarding protection of property rights, many of these reforms may have serious implications for society, and hence remain very sensitive. The consequences of such reforms are hard to assess ex ante, but will certainly be far-reaching. The high degree of uncertainty regarding the welfare impacts of structural transformation triggered by liberalization results in strong opposition from many corners of Indian and EU society.

Still, there are important interests at stake at both sides. The EU would favour a set of key reforms in India, in particular at the level of government procurement, liberalization of the service sector, especially in accounting, banking and insurance, and at the level of protection of investments by EU companies in India. Government procurement strategies in India often lack transparency and consistency, especially vis-à-vis foreign companies. This has for instance proved to be an impediment for European breweries wishing to export beer to particular states in India, where wholesale trade in alcohol is governed by parastatal agencies. Some of these parastatal agencies do not even have a procedure to source from foreign companies, which de facto restricts their procurement to domestic companies.

To date, many Indian markets remain heavily regulated, and foreign direct investment (FDI) remains limited or even prohibited in several sectors of the economy. In those sectors where FDI is allowed, foreign investments are not always protected, and especially the enforcement of intellectual property rights is a major political issue. In terms of trade facilitation, the EU would like India to make its customs procedures more simple, more transparent, and consistent across different states. Finally, the EU would also like India to cut back its broad range of anti-dumping measures.

From the Indian side, there are important interests in increased FDI inflows from Europe, as these inflows are often associated with improved access to capital and new technologies. On the other hand much is expected from a potential opening up of the EU IT and telecom sectors to Indian companies – and from a reduced administrative burden for short-term international mobility of Indian IT professionals. A first step in the right direction here is the recent introduction of the EU blue card, which facilitates entry into the EU labour market by highly skilled non-EU professionals.

However, a number of issues which are currently on the negotiation table remain particularly sensitive. Agricultural liberalization is one of such concerns. For example, the Indian dairy sector is dominated by small – often poor – household farms which are relatively inefficient according to international standards. Many fear that by lowering tariffs on dairy imports, small farms will be driven out of the market by dairy imports from the EU, and be left with few alternative sources of income.

The enforcement of intellectual property rights is another major subject of controversy, particularly for the pharmaceutical industry. India is often referred to as ‘the pharmacy of the developing world’ – as it develops a broad range of generic medicines based on existing medicines, once the relevant patents have expired. The EU would like to impose stricter rules on the production of generic medicines, for example by making it mandatory for generic medicine producers to conduct their own clinical trials for registration of the generic medicine, rather than relying on the clinical trials by the originator company. This is bound to push up prices of generic medicine production substantially.

Many other sensitive issues can be named. How they will be tackled, remains unclear; some of them, such as agriculture, may be left off the table eventually.

Conclusion

It is hard to predict when, and in what form, the EU-India FTA or BITA will be concluded. However, even if negotiations are lingering on, it is important to acknowledge that positive developments towards increased openness between EU and India have already taken place in the wake of the negotiations. One example is the introduction of the EU blue card, which will facilitate inward mobility of high-skilled Indian IT professionals. Another example is the opening up of Indian multibrand retail to FDI, a key reform which was announced only recently. Progress is being made; but given the magnitude of the issues at stake, negotiators are probably wise to use caution and proceed only gradually.

As yet, India is the only country in the South Asian Association for Regional Cooperation (SAARC) with which the EU has launched free trade and/or bilateral investment negotiations – most likely owing to the least developed country status of most of the SAARC countries. It may be expected, however, that once growth takes off in the remaining SAARC countries, and prospects for demand improve, EU will pay more attention to these markets as well. The EU already offers financial assistance to Pakistan for the implementation of the South-Asian Free Trade Area (SAFTA), which will unite markets in India, Nepal, Afghanistan, Bhutan, Bangladesh, Maldives, Sri Lanka and Pakistan.