



**Statement before the U.S. International Trade
Commission
Investigation No. 332-550**

***“TRADE AND INVESTMENT POLICIES
IN INDIA, 2014-2015”***

A Statement by:

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Chairman Broadbent, members of the Commission, thank you for inviting me to testify at the hearing today. I would like to note that, as a bipartisan think tank, CSIS as an institution does not take specific policy positions. The views in my statement and in my comments this afternoon are entirely my own.

We are coming upon the Modi government's one year anniversary. So far I believe the Modi government has 1) Done an excellent job of quickly opening new sectors to foreign investment, and making other policy changes that will positively impact foreign investors, 2) Had a mixed record of "fixing" those policy issues that had been the source of tension to the American business community, and 3) Made a few key mis-steps that have been the cause of new concerns to foreign companies. Overall, this year has clearly been net positive.

First, allow me to start by highlighting the single most important measure of how foreign companies see India's business environment- the trendline in actual trade and investment flows.

- At the end of February 2015, foreign direct investment for the most recent 12 month period is \$32.5 billion. That is up 38% over the previous 12 month period.
- At the end of February 2015, U.S. India trade for the most recent 12 month period is \$67.3 billion. That is up 5.1% over the previous 12 month period.
- At the end of April 2015, foreign institutional investment for the 12 month period is \$47.2 billion. That is up 640% over the previous 12 month period.

There is a vibrant debate over whether this dramatic increase is due to the *expectation* of a robust economic reform program under Prime Minister Modi, due to *actual reforms* which have taken place, or simply the *evolution of a larger business cycle* in India.

I do not intend to offer a definitive resolution of this debate, but will review the reforms that have taken place so far, as well as some mis-steps.

Looking back 12 months, both the strategic and business communities were dissatisfied with the relationship. India's declining growth rates and the looming national election triggered many short-sighted moves by the UPA government, covering both economic and social issues. The business community had, by and large, four main types of grievances: 1. Recent decisions in India on patents; 2. The introduction of compulsory local manufacturing rules in several sectors, 3. An increase in targeting foreign firms for massive cross-border taxation cases, and 4. A lack of progress on adopting important new market access reforms, particularly FDI caps.

The American business and strategic communities were generally excited about the Modi government's assumption of power in India in May 2014. At the very least, we were eager for a breath of fresh air. The Bharatiya Janata Party (BJP) came to power with India's first single-party majority in three decades. Paired with the pro-business image Mr. Modi earned as chief minister of Gujarat, expectations for economic reforms were quite high.

However, it is also critical to note that just by winning the lower house of Parliament, Mr. Modi's power is far from absolute. His party was, and remains, quite weak in the upper house of Parliament, or Rajya Sabha. Today the BJP controls 19% of seats in the Rajya Sabha. Even if you add together the other core constituents of the BJP's coalition, the National Democratic Alliance, they are only at around 25% of seats. The Congress Party alone controls a higher percentage of seats, at around 28%.

Another area where the BJP holds a weak set of economic levers is in encouraging state-level reform and execution. At the time the BJP took over the central government, they controlled only 5 of India's 29 states. That number is up to 8, but still far from a majority. This means that introducing economic reforms that alter the Constitution, such as a national Goods and Services Tax, have a very high level of difficulty. Constitutional amendments need a two-third majority in each house of Parliament, and the assent of a majority of states. It also means that major economic campaigns announced by the Modi government, such as the development of industrial corridors and smart cities, can only move as fast as state governments carry them out. The result will be quite mixed.

Third, it is an over-simplification to say that the BJP is a party of economic liberalizers. What they are, to their core, is an anti-Congress party. So their leaders have not bought into Congress Party concepts like "non-alignment" or "state-led development." So while the BJP is more likely to encourage the private sector, that concept is not always automatically extended to foreign firms.

Fourth, India has a massive trade deficit. India's deficit in goods trade has averaged \$161 billion the last four years. This data point is often buried behind the stronger "current account" scenario. India's services trade, foreign investment, and remittances combine to form a powerful buffer against foreign currency outflows. But the deficit in goods trade, which is seen as impacting people who tend to be on a lower economic standing than those who benefit from services trade and remittances, has triggered several anti-trade measures in recent years. And despite a 16% drop in India's oil import bill in FY15, India's goods trade deficit increased slightly. As a percent of GDP, India has the second highest goods trade deficit among the 20 largest economies in the world.

Allow me to review some of the biggest reforms actually carried out in the government's first 11 months in office. Some focus on market access, and others broadly relax rules allowing both foreign and domestic firms to compete more effectively. Prime Minister

Modi has set a high bar- he wants India to move on the World Bank's "Doing Business" index from number 142 to number 50.

- **Energy:** Wholesale reform of the coal sector, allowing the private sector- including foreign firms- to compete with the government-owned Coal India:
- **Energy:** Removal of government price controls on diesel:
- **Energy:** Increasing the government ceiling on pricing of natural gas:
- **Defense:** Increased the FDI cap in defense from 26% to 49% (with up to 100% on a case-by-case basis).
- **Defense:** Expedited the acquisition of key defense materiel (anti-tank missiles, combat aircraft).
- **Defense:** More than half of all defense products, previously reserved for government-owned companies, were opened to the private sector.
- **Construction:** Eased requirements governing FDI in the construction sector.
- **Transportation:** Opened the railways sector to 100% FDI (it had been closed before).
- **Taxation:** Reduced the use of "retrospective taxation" by creating a new review group in the Central Board of Direct Taxation (CBDT).
- **Taxation:** The government has shown new energy in resolving the huge backlog of bilateral taxation disputes. Many of these disputes involve American investors.
- **Insurance:** The government increased the FDI cap from 26% to 49%.
- **Pensions:** The Insurance Act amendment noted above had the related effect of increasing the FDI cap applicable to the pension industry from 26% to 49%.
- **Manufacturing:** A number of small, important steps including removing the last 20 items reserves for the small scale industries, extending industrial licenses, and allowing self-attestation for some types of clearances.

A few other major reforms adopted by the Modi government will have an uncertain impact. Two, in particular, are likely to have some type of profound impact:

- **Fiscal:** The Modi government is devolving more spending authority directly to India's states. In one single move, the government increased the share of federal taxes given directly to states from 32% up to 42%.
- **Abolishing the Planning Commission/ Creating New Body- NITI Aayog:** In what appears to be another strong break from its long dance with socialism, the Modi government may be in process of ending its reliance on "5 Year Plans," and focusing to a more consultative, flexible approach to facilitating the growth of India's states.

In a few areas we have seen the Modi government take economic decisions that have served to erode business sentiments. These include:

- **WTO Trade Facilitation Agreement:** The single-biggest dark cloud on economic policy hanging over the Modi government's first year, from the American perspective, is the decision to delay adoption of the WTO Trade Facilitation Agreement last summer. Ultimately India signed on, but only after negotiating a special carve-out for itself.
- **Model Bilateral Investment Treaty:** While the "final" model is yet to be released, the draft issued for public comment in the spring contains changes that will bother investors. These include removing the applicability of "most favored nation," making it more difficult to launch Investor-State Dispute Settlement proceedings, some open-ended language on credible reasons for expropriation (Investors should strive to meet host country development objectives). But also moves closer to the U.S. model in some aspects, in particular through the inclusion of labor and environmental standards. And, of course, this is only the model. Our models were always some distance apart; it will be up to the negotiators to see what is possible.
- **Minimum Alternative Tax (MAT):** MAT had not, in practice, been applied to FII's since it was created in 1997. But an FII that sought a related clarification in 2012 was told they were liable for MAT. Two years later, assessors caught on and began issuing tax notices to FII's. Jaitley moved pretty quickly to shut the door, but the 68 cases already in process have to continue their course.

As we sit here in this hearing the Modi government is pushing hard to secure sufficient votes for two critical legislative reforms.

- **Land Acquisition Bill:** One of the last bills passed by the UPA government adopted an onerous set of new rules governing the use of eminent domain. Under these new rules, the acquisition of large tracts of land is expected to take four years at a minimum. The Modi government is expending a tremendous amount of political capital in an attempt to carve out some critical types of projects from the Bill's mandate.
- **Goods and Services Constitutional Amendment:** Estimated to be one of India's most powerful economic reforms, potentially adding 1 or 2 percent to India's annual GDP.

Taking a direct look at the four areas of economic policymaking that had triggered the backlash by America's business community, we have a mixed record.

- **Patents:** No movement to close the government's ability to issue compulsory licenses, or amend section 3D of the patents act.
- **Local Manufacturing:** No changes to the many sectors that have compulsory local manufacturing rules, and some indication the list may be increased.

- **Taxation:** Good steps to resolve past disputes and slow the increase of new cases. But a few issues, often not directly controlled by the federal government, continue to spook investors.
- **FDI Caps:** Tremendous progress on increasing FDI caps as outlined above.

In summary, while we cannot claim this has been a perfect year in terms of liberalizing the economy, it has been one of the best years on record. Certainly well ahead of the first year of either the Vajpayee or the Singh governments. Though we can say that the focus has largely been on economic decisions with a prospective effect, with less attention on issues that had previously caused investor concerns.