Chapter - 11

NEPAL-INDIA TRADE TREATY AND WTO COMPATIBILITY

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Nepal has bilateral trade agreements with 17 countries. With the exception of the agreement with India, other agreements have played an insignificant role in expanding and diversifying Nepal's trade. India accounts for more than 50% of Nepal's total export and import.[64] Nepal's trade with India is even more substantive for agricultural products with India absorbing close to 90% of Nepal's total agricultural export and Nepal importing about 60% of agricultural products from India. The size of informal, unrecorded trade between these two countries is also estimated to be substantive. It is believed that most, if not all, of the trade between Nepal and India takes place within the framework of the bilateral trade agreement, and not under the most-favoured nation (MFN) terms. The bilateral agreement in force currently is the Nepal-India Treaty of Trade (the Treaty) negotiated in 1996 and renewed with changes in 2002 for a period of five years. The Treaty was largely in favour of Nepal, which was rolled back on some fronts in 2002.

All regional and preferential trade agreements, (RTAs and PTAs) like this Treaty, involve by design discrimination against countries that are not members of the agreement. In other words, such agreements violate the basic GATT/WTO principle of non-discrimination, notably the MFN principle of GATT 1994 Article I. There are however GATT/WTO rules that recognize these agreements and give a legal cover for them provided certain conditions and criteria are met. Given the overwhelming size of agricultural trade between Nepal and India, mostly within the framework of the Treaty, it is critical that the Treaty passes these tests and is WTO-compatible. This is much more important for Nepal than for India.

The main purpose of this chapter is to discuss the issue of WTO-compatibility of the Treaty. In doing so, the chapter also introduces the main provisions of the Treaty and its legal and economic aspects. The chapter is organized into three sequential sections that introduce the main provisions of the Treaty; discuss WTO-compatibility of the Treaty; and draw some conclusions there from.

The study is largely based on a careful analysis of the various individual provisions of the Treaty; as well as of the overall nature of the Treaty vis-à-vis the WTO rules applying to such trade agreements. It draws upon previous studies and commentaries where relevant, as well as discussions with government officials and other stakeholders. It also reflects the author's long association with trade policy in general and Nepal-India trade agreements in particular. Although the main focus is on the legal side, the section that follows immediately also discusses some economic aspects of the provisions of the current Treaty. A comprehensive economic analysis of the Treaty, however, is beyond the scope of this study. It is rather unfortunate that very little quantitative analysis has been undertaken in Nepal on economic impacts of the Treaty and its alternatives.

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[64] Nepal Overseas Trade Statistics 2002/03, Trade Promotion Centre, Kathmandu.

AN OVERVIEW OF THE NEPAL-INDIA TRADE TREATY

The focus here is on the 1996 Nepal-India Treaty of Trade[65] and changes/revisions made in the 2002 agreement. The 1996 Treaty has 12 Articles and several protocols to these Articles. In March 2002, an agreement was reached to extend the validity of the Treaty for a further five years (i.e. until 2007). This essentially meant the continuation of the 12 Articles and Protocols to Articles I, II, III, IV and VI, while the 2002 Treaty revised Protocols to Article V and added a new Protocol to Article IX. Table 1 provides an overview of all the Articles and Protocols.[66] Of the 12 Articles, Articles IV and V are particularly important for trade, the former addressing trade in primary products and the latter in industrial products. Some of the provisions of the Treaty are fairly complex, e.g. on rules of origin and procedures for the refund of excise duties, and cannot be summarized in the table. Given space limitations, the Articles and Protocols are introduced succinctly.

Besides the Preamble, Article I is also of a preamble nature, i.e. with some general statements like "mutual desire for promoting trade for mutual benefits" and that the two countries "shall undertake all measures to promote and expand trade". Of some practical significance is the Protocol to Article 1 that lists 22 trade routes (border points) for all products.

Article II states that both parties should try their best for the free and unhampered flow of goods to and from their territories, and thus seems to be stressing on trade facilitation. Its Protocol qualifies these goods as being of Indian and Nepalese origins only. The rest of the Protocol is about exceptions to the goods thus identified. Thus, there is no obligation for allowing free movement for the following types of goods: restricted for export to third countries; subject to control on price for domestic distribution (e.g. India's levy sugar); and prohibited for export to each other's territories to prevent deflection to third countries. These goods need to be listed and notified by the parties. Paragraph 4 of the Protocol makes a provision for the export of the restricted goods by one party if needed by the other party. This is to be done through annual quota allocations. As an example, if sugar is in India's list of restricted goods for being subject to control on price for domestic distribution, India may allocate export quota to Nepal if Nepal needs and requests for the product. A final provision states that the parties should take appropriate measures to prevent unauthorized imports of such goods.

Article III clearly states that both parties shall accord unconditional MFN treatment to each other, i.e. "no less favourably than that accorded to any third country". Its Protocol, however, is about the refund to Nepal of excise and other duties collected by India on goods produced in India and exported to Nepal. This is indeed a unique arrangement not found in PTAs elsewhere in the world. Two subparagraphs of the Protocol lay some conditions on the amount of the refund. First, the refund will not exceed the import duties levied by Nepal on similar goods imported from a third country. Second, Nepal shall not collect duties and charges on

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65 The full form of the Treaty is "Treaty of Trade between His Majesty's Government of Nepal and the Government of India".

66 The table is meant to only provide an overview or main features of the Treaty; it is neither complete nor accurate in a legal sense. Therefore, serious readers should refer to the original legal documents.

Table 1: **Gist of the Nepal-India Trade Treaty 1996, its Protocols and the Protocols of the 2002 Revision of the Treaty**

Article	The 1996 treaty		Protocols in 2002 revision of the Treaty
	Main text	Protocol	
Preamble	Strengthen economic cooperation; trade growth etc.	None	None
Article-I	Like preamble – explore and undertake all measures to facilitate and expand trade	Lists 22 routes (border points) for all trade	None
Article-II	Both parties to grant maximum facilities for free and unhampered flow of goods	Limited to goods of Indian and Nepali origin ("origin" not defined); additional provisions on exceptions (restricted/prohibited goods listed)	None
Article-III	General statement on MFN treatment in market access	Excise duty refund system (India to refund to Nepal); some rules on this	None
Article-IV	Duty-free and quota-free treatment to *primary products* on a *reciprocal* basis	Lists primary products/product groups (includes all unprocessed agricultural products and some processed products like rice)	None
Article-V	*Preferential* market access to Nepalese *industrial products* on a *non-reciprocal* basis	Preferential access subject to Certificate of Origin Some exceptions A "surge" clause introduced Some provisions on "additional duty" Special provisions for products from "small scale" units	Most provisions of the 1996 protocol replaced by following qualifiers Products manufactured in Nepal from Nepali and/or Indian materials Product transformation at HS 4 level with defined degree of processing Value addition criterion by allowing only up to 70% share of 3rd country materials in total value. Exception to "quota" products Certificate of Origin concept retained "Surge" clause moved to Art IX Some provisions on "additional duty" Special provisions for products from "small scale" units
Article-VI	Preferential treatment to Indian industrial products (exempt customs duty and quantitative restrictions) but not binding.	Nepal to waive additional customs duty on all Indian exports	None
Article-VII	About trade payments, foreign exchange etc	None	None
Article-VIII	Cooperate to prevent circumvention of laws, rules etc.	None	None
Article-IX	Exceptions to preferential access in case of some non-trade concerns.	None	A "surge" clause added. Surge, industry, injury, threat of injury defined.
Article-X	Exception on and some other ground	None	None
Article-XI	Regular consultations for smooth implementation	None	None
Article-XII	Valid till 2001 with automatic five-years extensions unless either party wished otherwise	None	None

imports from India up to the amount of the payment by India. Apart from its uniqueness not found in most or all PTAs around the world, the provision for the duty refund process also lacks transparency and is cumbersome in the settlement of the refundable amounts. The reason for this practice must be on administrative difficulties in exempting excise duties on products exported to Nepal because the common practice around the world is to exempt local taxes on export products to start with. The provision may also have some implications for Nepal's tariff policy.

Article IV states, "the contracting parties agree, on a reciprocal basis, to exempt from basic customs duty as well as from quantitative restrictions the import of such primary products as may be mutually agreed upon, from each other". Thus, this is one of the most important provisions of the Treaty from the standpoint of agricultural products. Note that the free trade provision applies on a reciprocal basis. Its Protocol lists 14 products or product groups eligible for such preferential treatment.[67] These products would also receive national treatment with respect to local taxes or charges in the territory of the other party. The last paragraph of the protocol is somewhat vague and seems to authorize the parties to take exceptions to the above provision.[68] The implications of the main provision of this Article are clear. Thus, Nepalese primary products have full access in the Indian market free of duty, charges or quantitative restrictions. The same applies to the Indian primary products in the Nepalese market. Originally, this was on the basis of non-reciprocity.

While it is difficult to quantify the overall gains and losses to Nepal of this reciprocity provision, the net outcome would vary by sub-sectors and commodities. The net gains also vary by regions in Nepal. For example, given that the Nepalese market is not fully integrated, Nepal's backward regions like the Mid-west and Far-west are more dependent on the free and unhampered access to Indian markets, than for example surplus products in other, more integrated regions of Nepal. In contrast, the latter regions will face more intense competition in Nepal itself with Indian products, e.g. fruits and vegetables in the Central region. There is virtually no study that quantifies these gains and losses, nor on the counterfactual of what would happen if Nepal-India trade in primary products is on a MFN basis.

Article V and its Protocol address trade in industrial products. The Article states that "…. the Government of India agrees to promote industrial development of Nepal through the grant on the basis of non-reciprocity of specially favourable treatment to imports into India of industrial products manufactured in Nepal in respect of customs duty and quantitative restrictions normally applicable to them". Presumably, these are all products other than primary products listed in Article IV. Thus, these would include such agricultural goods like sugar, cheese, butter, noodles, pashmina shawl, vegetable ghee, fruit juice, jams and so on. Comparing the

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67 The following primary products are listed: agriculture, horticulture and forest produce and minerals which have not undergone any processing; rice, pulses and flour; timber; *jaggery* (*gur* and *shakhar*); animals, birds and fish; bees, bees-wax and honey; raw wool, goat hair, and bones as are used in the manufacture of bone-meal; milk, home made products of milk and eggs; *ghani*-produced oil and oil-cakes; *ayurvedic* and herbal medicines; articles produced by village artisans as are mainly used in villages; *akara*; yak tail; and any other primary products which may be mutually agreed upon.

68 It reads as follows: "It is also understood that the aforesaid provisions will not preclude a Contracting Party from taking any measure which it may deem necessary on the exportation of primary products to the other".

1996 Treaty with the 2002 revision, it is clear that India's main concerns are with the provisions of this Article. While the main text of the Article was not changed, the Protocol to Article V was revised extensively, with provisions on rules of origin, product transformation and local content requirement and tariff quotas. Other provisions like Certificate of Origin, special treatment to products manufactured by small-scale industries and the issue of additional duties were continued from the 1996 version.

Article V, when juxtaposed with Article VI, which reads "…. His Majesty's Government shall endeavour to exempt, wholly or partially, imports from India from customs duty and quantitative restrictions to the maximum extent compatible with their development needs and protection of their industries" (note the words "shall endeavour"), implies that the provision is not binding for Nepal. The Protocol to this Article uses the binding word "will" in the case of waiving additional customs duty on all Indian exports. In practice, Nepal has been providing a partial percentage reduction from the MFN tariffs on imports from India, which means that the non-reciprocity mentioned in Article V is not 100%.

As space does not permit detailed discussion of all these issues, only some important features are highlighted here. For Nepal, the main question asked is how helpful has this provision been so far for Nepal's industrial development – the main stated goal in the Article – or will be in the future. Although this topic has been debated to some extent in Nepal, no comprehensive analysis has been undertaken. What is well known is that especially after 1996 there was a spurt of production and export of vegetable ghee, acrylic yarn, some copper products and zinc oxide, the four products for which India complained of import surges and low local content, and eventually imposed quota restrictions. Other success stories include noodles and products manufactured by Dabur Nepal and Nepal Liver[69]. A distinguishing feature between these two groups of industries is the degree of local content or value addition. India assigns high importance to this criterion for fear of trade deflection. The question asked here is to what extent Nepal should also be concerned with this provision because what is involved here is value addition, employment and backward linkages to agriculture in the case of agro-industries – some of the key distinguishing features of "genuine" industrialization.

Those who value these distinguishing features would support the local-content requirement of the Treaty as revised in 2002. This provision requires at least 30% local content (raw materials) in total value of the output, which is not a low level and so should indeed be desirable for genuine industrialization in Nepal. A counter-argument that is also often made is that in the early phases of industrialization, industries tend to rely heavily on imported raw materials and so the local content should be lower. In this context, a question that Nepal should be asking itself is whether there is a trend towards the export from Nepal of products with higher local content? If the answer is yes, the Treaty and this particular provision can be said to be helping genuine industrialization in Nepal, rather than the "bolt and screw" industries with minimum local contents. This is something that can be assessed with statistics, but does not seem to have been done so far.

[69] These industries have accounted for a sizable 20% to 25% of Nepal total exports to India.

In informal meetings and formal trade negotiating sessions, India has made arguments rather strongly that India is sincere to the objective of promoting industrial development of Nepal. They have argued that genuine industrialization is not about "diverting" imported raw materials to India with very little processing in order to take advantage of the restrictive trade policy of India. The cases of "wholesome" diversion of imported raw materials to India have remained a bone of contention for long time in trade negotiations with India, including in transit relations.

Nepal needs to be sensitive to these concerns of India, but more importantly for the sake of Nepal's own genuine industrialization. In recent years, Nepalese exports have suffered from some new provisions that India added in the 2002 revision of the Treaty, notably rules of origin, quota system for some products, canalization of imports through STEs and import surge. These provisions were mostly in response to the rapid growth of exports after 1996 of some of the products with low local contents, as noted above. It is unlikely that India will insist on too many ifs and buts for Nepalese products with high local contents. For the Nepalese government, thus, the choice is between spending too much negotiating capital on industrial products with low local content and on those that are rich in the distinguishing features of genuine industrialization as noted above.

Article VII provides for the payment for transactions in accordance with the national laws and regulations, while Article VIII is about bilateral cooperation to prevent violation of trade and foreign exchange laws and regulations. These Articles are not that important in the context of this paper.

Article IX provides for exceptions to the provisions in the previous Articles by allowing the parties to maintain or introduce such restrictions as necessary for various reasons, which include some commonly agreed safeguard measures in the WTO Agreements, e.g. protecting public morale, human, animal and plant life, national treasures, gold and silver and any other safeguard that is mutually agreed upon. The 1996 Treaty does not have a Protocol to this Article but a safeguard clause has been added as a Protocol in the 2002 revision of the Treaty.

A surge is defined similarly as in the WTO Agreements on trade remedy measures: "In the event of imports under the Treaty, in such a manner or in such quantities as to cause or threaten to cause injury to the domestic industry or a significant segment of it relating to the article, …". The remedy agreed is joint consultations. If this fails, appropriate remedial measures can be taken, but such measures are not specified. The Protocol also defines a number of terms, namely injury, threat of injury and domestic industry.[70]

The remaining three Articles are of lesser significance for trade. Article X is about safeguards and exemptions for protecting security interests or in pursuance of international conventions. Article XI calls for regular joint consultations while the main point made in Article XII is the automatic extension (renewal) of the Treaty for further five years.

[70] For details, see the chapter on import surges by Gautam et al. in this volume.

ANALYSIS OF THE TREATY IN RELATION TO THE WTO RULES

This section examines the Treaty in two ways. First, the individual provisions of the Treaty are examined separately vis-à-vis the WTO rules. Second, the Treaty as a whole is considered together to determine how this fits within the WTO framework. Where the Treaty as a whole is not WTO-compatible, the fact that some of the individual provisions are compatible does not help. However, this information is useful for modifying these provisions so that the Treaty can be made WTO compatible. In what follows, the individual provisions are examined, Article by Article, followed by an assessment of the nature of the Treaty as a whole. Boxes 1, 2 and 3 introduce three key WTO concepts/provisions that are critical for the analysis reported in this section. These are: Regional Trade Agreements, Enabling Clause and WTO Waivers.

The individual provisions of the Treaty and the WTO rules

The Preamble and Article I express overall objectives in terms of fostering economic cooperation and fortifying traditional market connections between the markets of the two countries, and so are compatible with WTO rules.

The text of Article II calls for maximum trade facilitation by both parties for free and unhampered movement of goods in each other's territories. There is nothing against this in the WTO rules and in fact is in line with the spirit of various WTO Agreements. The provision in the Protocol that calls for such treatment only for goods of the Indian and Nepalese origin appears discriminatory, but it is not clear in the WTO rules whether such a treatment is allowed for within a RTA. The rest of the Protocol addresses rules limiting the export to each other of goods whose prices and export are regulated for social reasons. Again, the WTO-compatibility of these provisions would depend on whether these exceptions meet the "substantially all trade" criterion of a RTA (Box 1).

The text of Article III speaks of MFN treatment to each other and so is essentially of a preambular nature. Its Protocol addresses the refund of excise duties. This is essentially an internal arrangement between the two parties of the PTA and although it appears discriminatory, it should be WTO compatible provided that the Treaty itself is WTO compatible (discussed below).

The full reciprocity of concessions for primary products in Article IV gives the impression that the Treaty is a FTA rather than a PTA because PTAs typically do not have reciprocity although this is possible. Thus, this provision should be looked at from the standpoint of the FTA rules. The two key requirements for a WTO-compatible FTA are that the formation of a FTA should not result into increased trade barriers to third parties and that the FTA should cover "substantially all trade" (see Box 1). The Nepal-India Treaty, during renewals in 1996 and 2002, did not raise trade barriers to others and so there is no problem here. As regards the second criterion, the primary products listed in the Protocol to Article IV seem to cover "substantially all" primary products and so the Article appears to be consistent with the FTA requirement. However, this requirement is for "all" trade, not just primary or agricultural products. Hence, this analysis is incomplete without first determining if

the Treaty also provides for trade preferences in a reciprocal way for "substantially all" non-primary products also. This is addressed in Article V of the Treaty.

Box 1:
The WTO Rules on Regional Trade Agreement

Most WTO Members are parties to one or more Regional Trade Agreements (RTAs). Some Members are parties to ten or more RTAs. From 1947 to early 1995, about 100 RTAs were notified to the WTO. The trend has accelerated since 1995 – when over 100 RTAs have been notified. The popularity of RTAs owes to many factors, both economic or trade and political. The two most popular forms of RTAs are Free Trade Areas (FTAs) and Customs Unions. Although somewhat different, preferential trade agreements (PTAs) are also often considered as RTAs defined broadly. A RTA can have as fewer as two members, e.g. the India-Sri Lanka FTA, in which case it may be called a bilateral FTA.

As a RTA involves the reduction or elimination of tariffs and other trade barriers among the members of the RTA only, this amounts to discrimination against imports from non-members. Thus, the very concept of a RTA goes against the basic principle of non-discrimination of GATT/WTO, notably the MFN principle of GATT 1994 Article I. However, GATT Article XXIV recognizes a RTA as a special exception to this principle and thus RTAs are considered WTO-compatible, provided certain conditions are met. The two key conditions are as follows. First, members of a RTA should remove tariffs and other barriers among themselves on *substantially all trade*. Although "substantially" has not been quantified formally, some proposals made by WTO Members in recent years speak of 80% or 90% of all trade, and that the exclusion of an entire sub-sector, e.g. agriculture or industry, would amount to "lack of substantial trade coverage". Second, the formation of a RTA should not result into new and increased barriers to trade for other countries. In the "spirit" of the WTO, a RTA is seen as a process of increasing trade liberalization, eventually leading to greater trade integration at the global level. It is in this sense that a RTA is seen as a complement to the multilateral trading system and not a threat to it. All RTAs thus formed should be notified to the WTO where RTAs are reviewed on the basis of the above criteria before they are approved as WTO-compatible.

In contrast to Article IV, Article V and its Protocol provide for preferential market access for manufactured products but on a *non-reciprocal* basis, i.e. to the Nepalese products in the Indian market. Non-reciprocity is not the distinguishing feature of a FTA but that of a PTA. Thus, while with Article IV the Treaty appears to be a FTA, it looks like a PTA with Article V, i.e. the Treaty is a mix of two different models of a RTA.

In Article VI, however, the non-reciprocity provision is diluted to some extent because Article VI calls for Nepal to endeavour, to the extent possible, to exempt wholly or partially customs duty and quantitative restrictions on imports of manufactured products from India. Nepal does this by providing partial reduction in the MFN tariffs. Thus, both in the spirit of the Treaty and in practice, the non-reciprocity as provisioned in Article V is not 100%. This, together with Article IV, brings the Treaty somewhat closer to being a FTA. The overall character of the Treaty not being clear thus, it is natural that there were some questions asked by other WTO Members on the partial exemption of import tariffs by Nepal.

As said earlier, Articles VII and VIII, and Articles X to XII are related to trade issues only indirectly and are of lesser significance in the context being discussed. There is nothing in these provisions that contradict WTO rules.

Article IX is about some commonly agreed safeguard measures that are used to justify exceptions to previous commitments. These are also found in WTO

rules and so are WTO compatible. A safeguard clause to respond to import surges was added as a Protocol in the 2002 revision of the Treaty. Safeguards against surges are common features of both the WTO Agreements and most RTAs, and so this provision is WTO compatible.

In summary, the main conclusion of the analysis is that many of the individual provisions of the Treaty appear to be WTO compatible. What is unclear and problematic is the overall nature of the Treaty, i.e. is it a FTA or a PTA or something else? This issue is discussed next.

The Treaty Vis-à-vis the WTO rules

India has been raising on occasions its growing concerns with the compatibility of the Treaty with the WTO provisions. India raised this concern particularly during the bilateral talks held in connection with the 2002 renewal of the Treaty. Some other WTO Members also raised their concern informally about the special trading relations with India during Working Party meetings and bilateral negotiations at the WTO. Moreover, at the time of the renewal of Treaty in March 2002, both Nepal and India had agreed to review and revise the relevant provisions in both the Trade and Transit Treaties in case either country faces difficulty on account of its WTO obligations, including complaints by third countries seeking similar preferential treatment after Nepal's accession. Although this was discussed particularly in relation to the preferential treatment accorded to products from small scale industries, this is a *prima facie* evidence that the provisions of the Trade Treaty are not fully compatible with the non-discriminatory principle of the WTO Agreement. Therefore, there is always some risk of challenge to some of the provisions of the Treaty that Nepal in particular should be prepared to face.

There were some reports, both in the media and from insiders to Nepal-India trade negotiations, that India had in recent years, particularly after Nepal's submission to the WTO for accession, expressed some dilemma on continuing the non-reciprocal preferential treatment to Nepalese manufactured products (but not on the reciprocal treatment for primary goods). This seems to be both due to trade reason, e.g. import surges and quota management issues, as well as to potential problems in defending the provision under the WTO rules.

***The Treaty as a bilateral Free Trade Agreement*:** The question asked here is the following – is the Treaty a FTA and so should it be justified on the basis of GATT Article XXIV? The answer is no – the Treaty is not an arrangement of the nature envisaged under Article XXIV of GATT. The Treaty is not in the form of either a FTA or a Customs Union between the two countries that would eliminate duties and other restrictive regulations in the conduct of the bilateral trade on a reciprocal basis. The Treaty is also not seen as an interim agreement leading to the formation of a FTA or a customs union. There is also a problem in the coverage of goods under the agreement – while the Treaty covers most primary products, the same is not the case with industrial products and thus does not meet the GATT Article XXIV criterion of “substantially all trade”. Thus, one way to make the Treaty compatible with this Article would be to conduct free trade in industrial goods also on a reciprocal basis.

***The Treaty as a Preferential Trade Agreement under the Enabling Clause*:** The Treaty is closer to a PTA than a FTA. Thus, the issue of WTO compatibility needs to be examined within the WTO rules governing a PTA. There are two main arrangements for a PTA: the "Enabling Clause" and special waiver. The Enabling Clause (Box 2) could be an appropriate provision for justifying the Treaty. Nepal is a LDC and India a developing country. As a developing country, India can grant trade preferences to a LDC. However, the problem is that the Enabling Clause does not allow discrimination against similar other countries, in this case the LDCs. There are two other LDCs in the SAARC region, namely Bangladesh and Bhutan, and 47 other LDCs elsewhere. If other other LDCs also ask for similar preferential treatment from India, it will be increasingly difficult to justify the Treaty on the ground of the Enabling Clause.

Box 2

The Enabling Clause

The Tokyo Round (1973-79) of the GATT laid foundation for the first time for a differential and more favourable treatment to developing countries and LDCs. Its 28 November 1979 decision on the *Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries* is popularly known as the *Enabling Clause*. It allows flexibility in the use of trade measures to protect infant industries and in the use of quantitative import restrictions to alleviate balance of payment difficulties, and, specifically, derogation to the MFN (non-discrimination) treatment in favour of developing countries. It continues to be applied as part of GATT 1994, Part IV (Trade and Development). It encourages developed countries to improve access to their markets without requiring the developing countries to reciprocate with similar treatment. More importantly, the Enabling Clause authorizes especially favourable treatment to the LDCs.

The underlying principle is that the rules of full reciprocity do not apply to negotiations between developed and developing countries. The latter are required to grant tariff concessions only on the basis of relative reciprocity, which takes into account the fact that, because of their lower level of economic development and their trade and financial needs, they may not be in a position to make concessions on the same basis as the developed countries. As the newly industrialized countries have reached higher stages of growth, they are required to make larger contributions and concessions in the form of tariff reductions and bindings than those at lower level of economic development. This concept is also known as "graduation" since it visualizes that as a developing country develops, it will graduate to a higher status enabling it to make tariff concessions and accept disciplines in other areas on the same basis as developed countries.

Special waiver for justifying the Treaty as a PTA: The third option is to obtain "special waiver" from the WTO General Council (Box 3). Several PTAs operate on the basis of the waiver, the most famous of these being the Lome Agreement (now the Cotonou Agreement) between the EU and some 80 countries, mostly former colonies, in Africa, Caribbean and Pacific regions. The PTAs between the Caribbean countries and the US (the CARICOM) as well as with Canada are other examples. These agreements have survived on the basis of the WTO waivers obtained periodically. This is not always simple and automatic, and WTO members may not agree to the waiver. These hassles are one reason why the EU decided to abolish the Lome/Cotonou PTA in favour of economic partnership agreements under which trade between the parties will take place on a reciprocal basis, thus making these agreement FTAs, and so justifiable under GATT Article XXIV. The question is would India and Nepal agree to jointly seek waivers for the Treaty from the

WTO on a periodic basis? Will the WTO grant such waivers all the time? What would happen if Bangladesh, Bhutan or other LDCs object to the request at the WTO? Thus, this route to make the Treaty WTO compatible is also fraught with uncertainties.[71]

There is also a border or frontier trade arrangement within the WTO rules under which waivers may be granted for trade taking place traditionally within a short distance on both sides of the border, e.g. 15 kilometres. However, the trade between Nepal and India does not look like a frontier trade. So it is very unlikely that the Treaty can be justified on the basis of this clause.

Box 3

Decision on Waiver for Preferential Tariff Treatment for LDCs

A separate Decision on Waiver for providing preferential treatment for LDCs was adopted in accordance with the Decision-Making Procedures under Articles IX and XII of the WTO Agreement agreed by the General Council on 15 June 1999. The Decision has reiterated the recognition of the WTO Agreement to the need for positive efforts of all Parties designed to ensure that developing countries and especially LDCs secure a share in the growth in the international trade. The Decision also took into consideration the Enabling Clause of 1979, the 1994 Decision on Measures in Favour of LDCs, and the statement contained in the Comprehensive and Integrated WTO Plan of Action for the LDCs adopted at the Singapore Ministerial Conference on 13 December 1996 and in the Ministerial Declaration of 20 May 1998 concerning integration of LDCs into the world trading system and providing predictable and favourable market access conditions for their products. The main decisions are as follows:

First, the provisions of paragraph 1 of Article I of GATT 1994 shall be waived until 30 June 2009 to allow developing country Members to provide preferential tariff treatment to products of LDCs, without being required to extend the same tariff treatment to any other Member.

Second, developing countries shall notify to the Council on Trade in Goods the list of all products of developing countries for which preferential tariff treatment is to be provided and subsequently modified on a generalized, non-reciprocal and non-discriminatory and preference margin.

Third, any preferential tariff treatment shall be designed to facilitate and promote the trade of LDCs and not to raise barriers or create undue difficulties for the trade of any Member. Such treatment shall not constitute an impediment to the reduction or elimination of tariffs on MFN basis.

The General Council shall review annually whether the exceptional circumstances justifying the Waiver still exist and whether the terms and conditions attached to the Waiver have been met.

CONCLUDING REMARKS

India has always been a major trading partner of Nepal. This relationship is likely to continue for a long time to come regardless of any formal trade regime with India and for reasons like Nepal's landlocked position, long and open border, free movement of labour and capital and currency convertibility. Unrecorded, informal

[71] A fourth option is also discussed some times. This is justifying the Treaty under the so-called "Grandfather Clause", which is said to provide the legal cover for continuing traditional trade and economic relations. This was not done, nor is this type of arrangement mentioned anywhere in India's Trade Policy Review reports of 1998 and 2002 by WTO Secretariat or in the Working Party Report on Nepal's WTO Accession. It seems that there was this type of provision in the early years of the GATT but does not seem to be in fashion lately.

trade across the border is also estimated to be substantial and will continue as long as price differences across borders exceed transport and transaction costs by a margin. Both Nepal and India being WTO Members now, any trade agreement between the two countries has to be WTO compatible. The foregoing analysis showed that this is not entirely the case with the current Treaty. Sooner or later the Treaty provisions would need to be changed to make them WTO compatible. Given the substantive trade that takes place between the two countries within the framework of the Treaty, any change in the regime could have marked economic implications. The rest of the sub-section summarizes the main observations based on the analysis in the preceding Section from two angles - WTO compatibility and economic issues.

Issues on WTO-compatibility

The main conclusion of the previous Section was that the Treaty has features of both the FTA and PTA. For example, the full reciprocity in trade in most primary products (Article IV) is a distinguishing feature of a FTA, while non-reciprocity in the case of the industrial goods (Article V) gives the impression that the Treaty is a PTA. Taken together, the Treaty is neither a FTA because it does not meet the "substantially all trade" criterion due to the non-reciprocal provision for industrial products, nor a PTA that can be justified under the Enabling Clause because India does not grant preferences to other LDCs. Obviously, there will be problems justifying the Treaty in the WTO under these provisions.

In view of the above, the question asked is what may be done here? At the time of the renewal of the Treaty in 2002, both Nepal and India had agreed to review and revise the relevant provisions of the Treaty in case either country faces difficulty on account of its WTO obligations, including complaints by third countries seeking similar preferential treatment after Nepal's accession.

First, the Treaty may be modified to look like a bilateral FTA – and named so formally. This would require Article V to be modified along the line of Article IV so that the "substantially all trade" provision also applies to industrial products on a reciprocal basis. While India should be happy to receive such preferences, this is unlikely to be acceptable to Nepal. Doing so, however, the Treaty becomes a FTA and so WTO-compatible under GATT Article XXIV.

Second, the Treaty may be justified in the WTO as a PTA under the Enabling Clause. This requires India to extend to all LDCs the same preferences granted to Nepal. There are several ifs and buts involved here. One, India may not agree to extend the preferences to Bangladesh in view of the stronger industrial base of Bangladesh compared with Nepal. The same may be true of some other LDCs.[72] Two, Bangladesh itself may not be interested in such a deal because of the reciprocal treatment to primary products and the strong competition that India poses on agriculture. Bangladesh may perceive that the overall loss in agriculture may not be offset by gains in industry. Three, this option will also undermine some of the bene-

[72] Bhutan, the other LDC from this region, may not raise this issue because first Bhutan is not a WTO Member and second, and more importantly, it has a special relation with India and has preferential access to that market. Afghanistan may raise this matter as a LDC once it becomes a WTO Member.

fits currently enjoyed by Nepal in the Indian market because of the competition with Bangladesh.

Third, the Treaty may be continued by obtaining periodic waivers from the WTO. This requires India to request and obtain the waiver. While this is possible, a waiver is only a second- or third-best way to continue trade agreements in view of the uncertainty involved. Other LDC members of the WTO, notably Bangladesh, could object to the waiver if they perceive sufficiently discriminated. So this cannot be a reliable option for the long run.

A fourth option that had received some attention in Nepal was to justify the Treaty under the so-called Grandfather Clause, by virtue of the old, traditional nature of the trade and economic cooperation between India and Nepal. But the Treaty was not presented in this way at the time of Nepal's accession, nor is there any indication that India has notified the Treaty in this way.

The fifth option considered here involves terminating the Treaty and going the SAFTA way. The SAFTA provides the middle way. Besides free or quasi-free trade among the SAFTA members on a reciprocal basis, SAFTA also embodies the principle of the Enabling Clause by giving preferential treatment, on a non-reciprocal basis, to all LDCs of the region (Bangladesh, Bhutan and Nepal).[73] A SAFTA that is sufficiently rich in non-reciprocal preferential treatment to LDCs should come closer to the current Treaty in terms of the margins of preferences, and at the same time be WTO-compatible also.

Some Economic Issues and Areas for Research and Debate

The focus of this study has been on the issue of the compatibility of the Treaty with the WTO rules, and not on economic aspects like gains and losses to Nepal from the Treaty or other alternative models discussed in this paper. Very little quantitative analysis has been undertaken in Nepal on this subject, which makes it difficult to debate the issues on an informed basis. For example, there is no study that has quantified the overall value of the trade preferences granted by India to Nepal under the Treaty, nor of the value of the preferences received by India in the Nepalese market. Such estimates would have to be the benchmark, along with the gains and losses at the level of commodities and sub-sectors, against which to measure changes in net gains following further revisions to the Treaty or under a different trade agreement altogether. These alternatives discussed in this paper were: i) a bilateral FTA that is compatible with GATT Article XXIV; ii) a PTA that is justified under the Enabling Clause or through waivers; iii) no special trade arrangements other than SAFTA; and iv) the MFN regime without special trade relations. For lack of quantitative analysis of these alternatives, the rest of this subsection summarizes some of the main views and arguments made by various stakeholders in Nepal. Perhaps the most commonly discussed topic is the advantages and disadvantages of the current Treaty in relation to a MFN regime.

One popular view is that the bilateral agreement with India has not contributed much to Nepal's agricultural and industrial development, as well as to exports.

[73] In the absence of the SAFTA, there is always the sixth option that is: trading with India on a MFN basis.

Moreover, the PTA has merely perpetuated dependency on the Indian market rather than helped in diversification, which is a goal in itself for Nepal. It is further argued that the PTA has been instrumental in misdirecting Nepal's industrial capital to "bolt and screw" type of industries that are not in Nepal's interest, i.e. industries that do not add much value locally, create employment and create or strengthen backward linkages. In addition, some claims have been made that the value of preferences under the Treaty is not as high as it appears when various indirect costs typically associated with a PTA are taken into account. These PTA-related costs that do not normally apply in a MFN regime include additional costs involved in complying with the rules of origin, uncertainties associated with restrictions and exceptions negotiated from time to time – often on an *ad hoc* basis - and restrictions and quota systems often imposed arbitrarily on the ground of import surges.

In the case of primary products (mainly agriculture), preferential trade with India is on a reciprocal basis. This means that India as a big economy benefits more from preferential margins, which should also be taken into account in the above calculations of gains and losses to Nepal. This is also so because Indian exports are typically higher-value processed products. Thus, the argument goes, the real worth of the current PTA relative to the MFN trade regime may not be as high as it is commonly held.

There is also a strong feeling in Nepal that the current regime of free trade in primary products (agriculture) on a reciprocal basis is not helpful to Nepal's agricultural development. It is claimed that this regime has undermined Nepal's competitiveness in the Nepalese market itself and has often led to import surges. While India can also make the same claim, the impact would differ sharply because of the relative size of the two economies. It is also said that India is also competitive because of high levels of agricultural subsidies. These arguments parallel the comments made by many developing countries that they can not expose their agriculture to exports from the OECD countries because of subsidies. A counter argument is that the availability of cheaper Indian food products (e.g. wheat, rice) has benefited consumers in Nepal, most of them poor and food insecure. Thus, there are arguments on both sides. But there is hardly any analysis that has quantified these gains and losses and, as a result, these debates have been taking place in Nepal without the benefit of sound facts and figures.

Proponents of the current Treaty point to ground realities. They argue that preferential margins are very high for Nepal because Indian economy is still fairly highly protected. The economic shocks and adjustment costs involved in a move to the MFN trade regime would be too high for the Nepalese economy to bear. Thus, the argument goes, the above statements make sense only when the preferential margins shrink considerably, i.e. when India's average MFN tariffs fall to relatively low levels. So, until then, the effort should be on preserving the Treaty. This side also argues that it is important to take into account Nepal's ground reality – which is the long, porous border with India and the high dependency on Indian markets of numerous small farmers and traders, especially in remote areas like Mid-west or Far-west regions. Much of this trade is unrecorded and takes the form of frontier-trade that is difficult to control. This trade is very likely to come under much greater scrutiny under a MFN trade regime. Moreover, under that regime, even the formal

part of Nepal's exports of primary products may be subjected to non-tariff barriers that some of the industrial goods face currently, e.g. canalization of imports through State Trading Bodies, lack of transparency on customs valuation, and sanitary and quarantine barriers, in addition to paying the applicable MFN duties. The relevant WTO Agreements leave much room for interpretation in these areas, and so trade facilitation often becomes a matter of good faith between two trading countries. This "faith" is likely to diminish under the MFN regime. Thus, overall, these ground realities need to be taken into account in any computation of, and the debate on, net gains to Nepal of alternative trade regimes.

The SAFTA angle is important to this debate. Under SAFTA, the total value of preference for Nepal would certainly be lower than under the current Treaty. However, there are also some advantages. Nepal does not have to grant to India full preferences for primary products, nor the partial preferences for industrial products. Other benefits include much more predictable trade practices as various trade provisions would be regionally negotiated, enforced and monitored. These include for example disciplines on import surges, rules of origin, tariff quotas, technical standards, and so on. In addition, some of the asymmetrical trade relations with India that Nepal claims to have been detrimental for itself would disappear under SAFTA. The main disadvantages under SAFTA, relative to the Treaty, include much shorter list of products eligible for preferential access in India, reduced margins of preferences, and competition with Bangladesh and Bhutan in the Indian market. The more effective the SAFTA is in the area of preferences, the more attractive the SAFTA option would be for Nepal, relative to the Treaty. Moreover, this model will have a structured mechanism for negotiations than in the case of bilateral negotiations, which tend to be ad hoc as well as often at the will of naturally the bigger partner. Thus, this seems to be a logical way out of the negative aspects of the bilateral Treaty with India without completely losing out on its positive aspects.

From the standpoint of a longer time horizon, Nepal's heavy dependency for a long period on a single market, i.e. India, for Nepal's industrialization and trade has resulted into frequent economic instabilities as well as low level of industrialization, confined mainly to primary products and manufactured goods with very low value addition. This is perhaps one reason for Nepal joining not only the WTO but also BIMSTEC, in addition to SAPTA/SAFTA. As said above, the adjustment costs involved in moving to such multilateral and regional trade agreements in relation to the traditional bilateral trade relations with India may be high in the short run. However, experiences from other parts of the world have shown that the potential gains from access as well as exposer to much sophisticated markets with latest technology will more than offset the short-run adjustment costs, thus helping the economy to grow in a much more robust path.

In conclusion, therefore, the following issues/topics appear pertinent for further analysis and debate.

The desirability of the SAFTA approach as the middle and WTO-compatible alternative to a MFN regime and the current preferential Treaty: Notwithstanding the outcome of a quantitative analysis on net gains from alternative trade regimes, there are some problems with the WTO compatibility of the current Treaty. The

Treaty may be modified as discussed above so that it can be justified as a FTA or a PTA under the Enabling Clause. On the other hand, a SAFTA that meets the WTO's "substantially all trade" criterion and has a reasonable degree of preferential treatment for LDCs members is both WTO-compatible and avoids shocks to sub-sectors that currently benefit from preferential market access in India. Nepal needs to consider this middle path seriously and perhaps deploy its full negotiating capital on it, i.e. to work with India in particular to make sure that SAFTA incorporates in it some of the genuine preferences that Nepal has been receiving currently under the Treaty or would like to receive in selected commodities/sub-sectors.

***Quantification of benefits and costs of alternative trade regimes*:** In order for the above debate to take place on an informed basis, it is essential that there are analyses that quantify the gains and losses from alternative trade regimes. These regimes are: i) Nepal-India Trade Treaty as it is, or with some reasonable modifications; ii) a SAFTA that meets the WTO's "substantially all trade" criterion and has a reasonable degree of preferential treatment to LDC members; and iii) a MFN trade regime. Such studies should quantify, or at least provide insights qualitatively, the sub-sectoral and distributional impacts also.

***The role for the Ministry of Agriculture and Cooperatives*:** The MoAC has not traditionally been involved in a significant way in the analysis of trade issues and in trade policy formulation. Given the importance of agriculture in the economy, this role has to change. The best way for the MoAC to get involved into these issues and to influence policy would be to strengthen its analytical capability on agricultural trade issues of the sort addressed in this chapter. The Ministry could undertake some of the studies discussed above for agricultural commodities, on its own or in collaboration with the MoICS as well as the NGOs and private sector. It could for example identify commodities/sub-sectors and agro-based products with high preferential margins in the Indian market as well as with strong backward linkages to the agricultural sector. Nepal's negotiating capital with India could then be focused on these commodities/sub-sectors on a priority basis. In the past, trade negotiations with India have often suffered for lack of informed analyses; the MoAC could make substantive contributions to the trade negotiations by generating these analyses.