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Essays in Indian Trade Policy

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Export-Import Bank of India (Exim Bank) instituted the International Economic Research Annual (IERA) Award in 1989. The objective of the award is to promote research in international economics, trade, development and related financing, by Indian nationals at universities and academic institutions in India and abroad. The study titled '*Essays in Indian Trade Policy*' is based on the IERA Award 2017 winning thesis by Dr. Amrita Saha, Post-Doctoral Researcher at the Institute of Development Studies, University of Sussex, UK.

Introduction

The importance of trade policy, especially in its role of securing balanced outcomes across disparate needs in the economy, has been extensively studied in economics and politics. It is widely acknowledged that trade policy is governed by complex sets of interactions between business /industries and government as agency of the State, with profound impacts on the development and design of trade policy reforms. To a large extent, such interactions have the ability to ascertain whether trade policy is economically appropriate and feasible, in addition to being politically acceptable. There has only been limited empirical research to explain these interactions shaping trade policy outcomes in developing countries. This study aims to contribute towards this gap by examining the case of Indian trade policy. It studies these interactions as industry lobbying to convey information signals that are useful to trade policy makers and help engender government responsiveness to business concerns. To theorise the influence of such interactions on trade policy outcomes, a simple modified framework of a structural political economy model (the 1994 seminal work of Grossman and Helpman's protection-for-sale, PFS henceforth) is adopted. Further, empirical evidence is provided by exploiting variations in trade, applied Most Favored Nation (MFN henceforth) tariffs and industry-government interactions data for the Indian manufacturing sector.

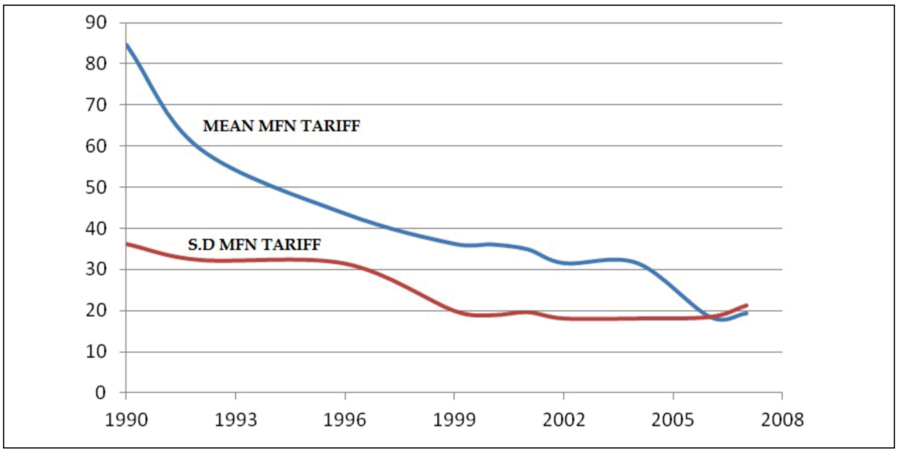
Political Economy in Indian Trade Policy

India is an interesting case study for interactions between industry and the government, with a seemingly likely impact on India's trade policy stance, owing to at least three key reasons which are discussed in turn. First, while India has always acknowledged the importance of the international trading system, it has equally always stressed domestic political imperatives in determining trade policy. Until economic liberalization in the 1990s, domestic interactions between industry and the government for trade policy was only at the margin. By 2000, the policy scenario was transformed such that domestic business interests could effectively determine negotiating positions by communicating with the apex organization of Ministry of Commerce and Industry (MOCI), which oversees Indian trade policy. Industry involvement in multilateral WTO negotiations also served to heighten government responsiveness to domestic business concerns.

Second, India historically had among the highest trade barriers in the world, so that inter-sectoral differences are likely to be easily observable. Figure 1 shows that the average (mean) applied MFN tariffs (at the 4 - digit of National Industrial Classification) for the manufacturing sector stood at a high of 85 per cent in 1990. Post the IMF mandate in 1991, these tariffs reduced to 44 per cent by 1996. The study finds that the standard deviation (S.D.) of tariffs dropped by half during the same period but still remained quite high, between 32-36 per cent. These changes in applied MFN protection from 1990-2007 present a good case to examine inter-sectoral differences and the extent to which political economy factors can be used to understand these.

Third, while the reforms of 1991 were essentially apolitical, having been imposed by the IMF, subsequent multilateral and unilateral reforms arose from domestic political processes and thus permitted significant cross-sectoral differences. Post-1991, the MOCI took cognizance of the fact that India's increased engagement in international negotiations stimulated overlaps across its fragmented ministries and sectors. This further required a greater number of domestic interactions and meetings aimed at mediating differences across sectors. The government participated in business association meetings at home to inform its multilateral agenda. These associations included bodies such as the Confederation of Indian Industry (CII) and the Federation of Indian Chambers of Commerce and Industries (FICCI),

Figure 1: Mean and Standard Deviation (S.D.) of MFN Applied Tariffs in India (%), 1990-2007



which became very active in the 2000s. Associations sought to combine the interests of domestic business with the imperatives of economic liberalization.

The Case of Applied MFN Tariffs

The applied MFN tariffs present an interesting case to capture the extent to which tariff changes were a result of domestic political concerns. Since the tariff changes in the early period – roughly from 1990 to 1998 - are attributable to the IMF mandate and Uruguay Rounds, where international constraints clearly played at least some role, the study draws a distinction between the sub-periods of changes pre-1998 and those post-1998. Examining MFN tariff changes in some detail, Figure 2 outlines the linear relationship between pre-reform MFN applied tariff levels and changes in the period immediately after liberalization, from 1991-1996. This uniformity is evidence that the tariff changes in this period were in fact exogenous. After 1997, different sectors were characterized by uneven levels of liberalization. This suggests that protection may have been used selectively after 1997 to meet certain political economy objectives. In fact, the linear relationship disappears between the immediate post-reform tariff levels in 1999 and tariff changes from 1999-2001 in Figure 3, and weakly re-appears between 2001 and 2007 in Figure 4. The weak linearity reflects the fact that, by the latter half of the 2000s, most changes in applied MFN tariffs had already occurred. Overall, the changes across the period are suggestive of the endogeneity in tariff protection across manufacturing sectors in India, and seem to suggest the need for a political economy analysis.

State-Business Interactions in Indian Trade Policy

The nature of political economy characterizing Indian trade policy-making has been quite dynamic. This dynamism is reflected in the typology of interactions between businesses / industry and the government as agency of the state for trade policy which have evolved from "direct individual business access to the government" to "collective influence of business as associations" and finally, towards a "duality in access".

Pre-Liberalization: Individual Business Access to State

Trade policies in India prior to 1991 met the interests of few big businesses that were able to influence the content of trade policies. This was the era of central planning, when the State retained autonomy of agenda. High levels of trade protection were in place to protect infant industries considered vital to the country's economic growth. With few big businesses, state-business relations prior to liberalization were characterized by direct and individual access to the government for specific concerns. Industries only occasionally reacted to policy decisions and resorted to approaching the government directly. It appears that the policy regime in place during this period was not conducive to collective action.

Liberalization: Transformation towards Collective Business Access to State

The IMF support to India, in the face of an external payment crisis in 1991, was conditional on an adjustment program of structural reforms. For trade policy, this included a reduction in the level and dispersion of tariffs, and the removal of quantitative restrictions on imported inputs and capital goods for export production. Immediately after the 1991 reforms, confronted with the need to raise funds to finance the ruling party's campaign for the 1994 state elections, the incumbent government turned to large industrial houses for financial support. The business groups in turn formed an organization, called the Bombay Club, consisting of a group of prominent Indian industries voicing concerns about – and seeking the reversal of – trade reforms, and demanding greater protection for

Figure 2: Pre-reform MFN Tariff changes 1990-1996

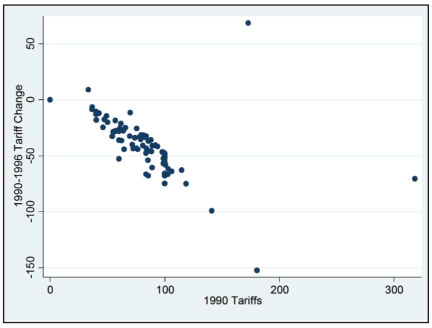


Figure 3: MFN tariffs and tariff changes 1999-2001

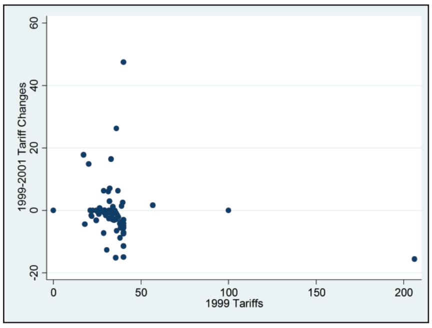
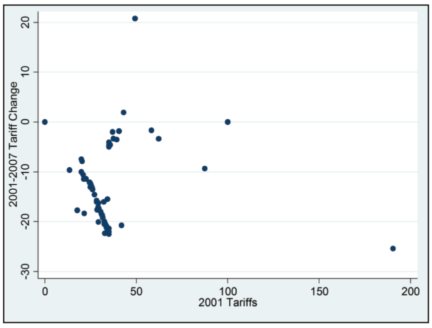


Figure 4: MFN tariffs and tariff changes 2001-2007



their industries from the surge in import competition. This seems to have marked the beginning of a transformation of business influence on trade policy – from individual business to collective business in the form of associations.

Post-Liberalisation: Duality in Business Access to State

Post-liberalization, the elimination of licensing and the introduction of competition accompanied by an emerging pattern of coalition governments potentially reduced the pay-offs to individual access. At this stage, there started evolving a duality in business interactions with the government that consisted of organized industry associations in addition to direct individual business access. Indian business also began to look at market opportunities abroad, including overseas investment. India continued on the path towards further trade liberalization in the post reforms post-reforms era. Sectors in India were characterized by uneven levels of liberalization, as also evidenced in the endogeneity in tariff protection assigned across manufacturing sectors in India in Figure 3. The political economy of Indian trade policy is, no doubt, evidence of political circumstances and development realities that often govern trade policy choices. These choices have a compelling link to the complex interplay of industry-government interactions in shaping policy outcomes. The study endeavors to offer empirical and theoretical insights on the link(s) between these interactions and choices.

State-Business Interactions as "Industry Lobbying to Transmit Information Signals"

State-business interactions are studied as industry lobbying, enabling the strategic transmission of information to the government. These interactions arise due to uncertainty about how policies map into consequences, as elections or employment outcomes. Such uncertainty opens the space for business lobbying groups to provide policy-relevant information to the government. However, not all groups will have the same influence through interactions and so, it is likely that some sectors will make a better case for trade protection than others. The sectors making a better case for protection will send 'signals' – such as information on pressing labour issues or other strategic reasons– which makes the government self-interested to supply protection to that business/industry. The study place this idea of industry lobbying to transmit information signals at the centre of the modified political economy framework.

Industry Lobbying by Means of Associations

In India, membership to associations is often seen as a more legitimate means of interacting with the government. Associations have close ties to the government and are seen as sources of crucial trade policy information. These associations include especially the apex bodies of CII and the FICCI that sponsor and participate in general policy debates. Using information on firm memberships to associations, a new binary indicator 'political organization' based on data from the World Bank Enterprise Survey (WBES) is constructed. This indicator identifies sectors as either organized to lobby or unorganized. Using this binary measure, the study begins by estimating the standard version of the political economy model (PFS) with the new measure for political organization, asking "Has Protection really been for Sale in India?"

Lobbying Effectiveness and its Determinants

Despite the economics profession's attachment to the policy of free trade, protection is still common and among the questions it still poses, one of the most recurrent ones is "Why do some sectors receive higher trade protection than others?". Some sectors are more effective in presenting their case for trade protection than others. Quantifying the effectiveness of industry-government interactions in obtaining policy outcomes has been a challenging task in the literature. The evidence for India in this regard is negligible. The study introduces lobbying effectiveness to measure industry-government interactions with the assumption of government placing different weights on different sectors. The different weights are explained by some sectors signalling the possession of relevant information of interest to the government prior to setting trade policies. To account for lobbying effectiveness, a simple modification to the standard version of the theoretical model (PFS with Lobbying Effectiveness) is introduced. Additionally, the study examines what determines such effectiveness.

Lobbying Effectiveness & Additional Political Factors

A continuous measure based on the firms' membership to industry associations in each sector as a proxy measure of lobbying effectiveness is constructed in the study. Using the proxy measure, the theoretical framework including lobbying effectiveness is estimated, asking the question: "Is Protection still for sale with Lobbying Effectiveness?". The analysis also recognizes that there may be additional political economy factors explaining the variation in trade protection besides the estimated effectiveness in interactions captured by membership to associations. Such factors can be potential substitutes or complements to lobbying by memberships and do influence trade protection, specifically in developing countries such as India. The modified theoretical model (PFS with Lobbying Effectiveness & Additional Political Factors) is further extended by adding such factors.

Single & Dual Lobbying Strategies

To complement the structural analysis in this study with information on the actual trade policy process in India, a primary survey of manufacturing firms conducted. Using this data, the choice of lobbying strategy that included collective lobbying ("Join Hands") by a group of firms or individual lobbying ("Walk Alone") by a single firm, was examined. A distinction was drawn between the use of each of these single strategies and a dual strategy (a unique combination of collective and individual lobbying). The following questions are asked. First, "What lobbying strategies do firms use for trade policy influence?" Second, "How does firm choice of lobbying strategy links to specific trade policy outcomes?" Finally, "What drives firm lobbying strategy for trade policy influence?" An understanding of the factors affecting the choice of lobbying strategy for trade policy has important implications for democratic policy-making by offering evidence to recognize the types of lobbying strategies and their influence across different trade policy instruments.

Key Findings

The aim of this study is to contribute towards the limited literature on political economy of Indian trade policy. Key findings are summarized below.

Protection has been for sale in India since 1999

Based on findings from the standard political economy framework (PFS), with the new political organization measure, the study finds that protection has been for sale, but only in the years following 1998. This is opposed to findings for the year. 1990 in the existing literature, which reports protection for sale in this year. While the difference is difficult to explain, it is plausible that political economy factors played only a minor role in setting protection levels in 1990, as most manufacturing industries were publicly owned at that time.

Protection for sale with Lobbying Effectiveness

A simple modification to the political economy model yields a structural framework (Modified PFS) that can be used to provide estimates on lobbying effectiveness using data varying across sectors and time. The most effective sectors have high deviation in lobbying effectiveness from the average effectiveness of the manufacturing sector, the less effective sectors have lower deviation in lobbying effectiveness from the average effectiveness. Effectiveness estimates of industry-government interactions for trade policy outcomes appear surprisingly consistent with what has been observed in the political economy of Indian trade policy.

Lobbying Effectiveness Estimates

It is interesting to note that clear changes are evident while comparing effectiveness for the entire period 1990-2007, compared to the sub-periods. Across the two sub-periods of pre-1998 and post-1998, government decision-making became highly responsive to business concerns. Overall effectiveness for the manufacturing sector is lower in the pre-1998 period than in the post-1998 period. With evidence in the literature suggesting strong interests from few big individual businesses in the former period, it is likely that these few individual firms were effective in lobbying in this early period. Liberalisation brought the elimination of licensing, introduction of competition and an emerging pattern of coalition governments that marked the beginning of collective lobbying and an increase in lobbying effectiveness. Further, the sector-wise estimates suggest that the *Motor Vehicles* sector was the most effective sector over the entire period of 1990-2007. But *Distilling, Blending of Spirits* was the most effective sector in the years since 1998. The sector *Electronic Valves and Tubes* was the least effective for the years before 1998, with *Aircraft and spacecraft* the least effective after 1998.

Geographical Proximity & Competition in Lobbying

The study finds that manufacturing firms producing similar goods are competitors. This competition effect reduces the positive impact on lobbying effectiveness from being geographically close. Hence, within a sector, firms in proximity and producing similar goods compete to lobby rather than cooperating or free-riding. The importance of competition over free-riding suggests the role of market structure in Indian manufacturing and how that can influence the direction of policy changes.

Protection is for sale (only) for very effective sectors

Based on findings from the modified political economy framework (Modified PFS), it is found that protection is for sale, but only for those sectors that are very effective in lobbying via associations, achieving positive trade protection. Additional political economy factors that reflect the firm-specific strength of a sector, appear to be substitutes in terms of lobbying strategy (PFS with Lobbying Effectiveness & Additional Political Factors).

Indian manufacturing firms join hands while walking alone to lobby the government

The study finds that firms tend to lobby collectively for a public good, and lobby individually for firm-specific outcomes. The unique finding is that firms preferred the dual strategy compared to the exclusive use of a single strategy. Preference for a dual strategy is explained by groups lobbying for changes in current policies, while each single strategy is generally used to defend a single existing policy.

Competition effects dominate lobbying for Indian Trade Policy

The likelihood of adopting a dual lobbying strategy is higher in sectors that are characterized by low output concentration (dispersion is higher), such that firms increase their chances of trade policy influence. Therefore, when there are several firms in a given sector producing the majority of the output, it is likely that they compete for influence on trade policy. This suggests a strong competition effect (driving cooperation and individual lobbying) over any free-riding driving firm strategy to lobby for trade policy influence in India.

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