

NEPAL-INDIA TREATY OF TRADE: AVENUES FOR AMENDMENTS

June 2023

Nepal-India Treaty of Trade: Avenues for amendments

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Published by



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The study for this report was supported by The Asia Foundation. The views in this report do not necessarily reflect those of The Asia Foundation.

Suggested citation: Pandey, P., Kharel, P., and Dahal, K. 2023. *Nepal-India Treaty of Trade: Avenues for amendments*. Kathmandu: South Asia Watch on Trade, Economics and Environment (SAWTEE).

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Introduction

The Nepal-India Treaty of Trade governs formal trade between Nepal and its largest trade partner. From the most liberal treaty of 1996 in terms of market access conditions for Nepal to the 2002 revision notable for its introduction of trade restrictions to the 2009 revision that included a provision potentially paving the way for the mutual recognition of standards-related certificates, Nepal-India trade agreements have witnessed considerable changes since the first such agreement with independent India was signed in 1950. A constant feature of the bilateral trade relationship in the last two decades has been a galloping trade deficit facing Nepal. Nepal's merchandise exports to India are under 30 percent of their potential.²

The 2009 treaty was automatically renewed without any changes in 2016. According to Article XII (b) of the treaty, it shall remain in force for a period of seven years and shall be automatically extended for further periods of seven years at a time, unless either of the parties gives to the other a written notice, three months in advance, of its intention to terminate the treaty. This treaty may be amended or modified by mutual consent of the contracting parties. In 2023, there is an opportunity for Nepal to negotiate revisions to the treaty to safeguard its trade and development interests.

Although Nepal gains duty-free access in India for almost all of its products, some provisions of the treaty constrain Nepal's exports to India. Furthermore, some of the reciprocal provisions of the treaty do not pay heed to the huge asymmetry in the size of the economies and their levels of development. What follow are suggested amendments that could mitigate the main deficiencies in the current version of the treaty, as well as implementation and miscellaneous issues that need to be addressed to make bilateral trade more mutually beneficial.

² Sanjay Kathuriya and Priya Mathur, "South Asia: A Work in Progress," in *A Glass Half Full: The Promise of Regional Trade in South Asia*, ed. Sanjay Kathuriya (Washington, D.C.: The World Bank, 2018), 27-85.

Ensure duty-free quota-free access to all Nepali exports without any exceptions

India has imposed quotas (Tariff Rate Quotas) on four products (Para 1(d) of the Protocol to Article V), that are of export interest to Nepal (Table 1). The administration of these quotas is riddled with hassles, designed to discourage imports even within the quota. Since the treaty allows safeguard measures (which are temporary in nature and need to be backed by a detailed investigation) to be taken against imports that cause or threaten to cause serious injury to domestic industry, there is no need for quotas, which are far more trade restrictive.

There are no such quotas in India's scheme of trade preferences to products originating in LDCs at the global level and in India's scheme of preferential tariffs to products originating in LDC members of the Agreement on South Asian Free Trade Area (SAFTA).

Table 1: Quotas imposed by India on Nepali products

S.N.	Nepali product	Quantity in MT per year
1	Vegetable fats (Vanaspati)	100,000 (One hundred thousand)
2	Acrylic Yarn	10, 000 (Ten thousand)
3	Copper products under Chapters 74.00 & Heading 85.44 of the H.S. Code	10,000 (Ten thousand)
4	Zinc Oxide	2,500 (Two thousand five hundred)

Source: Nepal-India Treaty of Trade, 2009, renewed on 2016.

Note: Any quantity above the specified amount will be allowed to be exported under most-favoured nation (MFN) rates of duty.

Alcoholic beverages, tobacco and cigarettes, and perfumes and cosmetics with non-Indian/non-Nepali names attract most-favored-nation (MFN) rates (Annex E of the treaty). It is noteworthy that some products in the perfumes and cosmetics category are accorded preferential tariff treatment in India's global preferential tariff schemes for LDCs, while these products are excluded entirely from its sensitive lists for LDCs under the SAFTA Agreement.

Given the fact that the margin of preference enjoyed by Nepal has been eroding because of tariff preferences also accorded to other LDCs' exports³, India's free trade agreements (FTAs) with other nations, and decreasing applied tariff rates, there are grounds for the current exceptions to duty-free access for Nepali products to be lifted.

Waive the provision of unconditional MFN treatment to create space for trade negotiations

Article III of the Trade Treaty has the provision: "Both the Contracting Parties shall accord unconditionally to each other treatment no less favourable than that accorded to any third country" with regard to customs duties, charges, and quantitative restrictions. In simple terms, what Article III entails is that if Nepal were to sign any bilateral or regional trade agreements, the preferences accorded in such agreements will automatically be granted to India as well, even if India were not a party to the agreement. This provision significantly curtails Nepal's ability to enter into free trade agreements or customs union agreements as potential trade partners will not have much of an incentive to do so given that India stands to free-ride on the tariff concessions offered by Nepal. Similarly, there could be products on which Nepal is in a position to grant preferential tariffs to some other trade partners (for example, the likely adverse impact on domestic producers is limited) but not to India. This provision, in short, constricts Nepal's trade negotiation space. Thus, this provision must be waived considering the negative impact it has on Nepal's ability to enter into trade agreements with other nations. The following should be added to Article III: "The provision shall not apply to any preferences and advantages accorded to any customs union, a free trade area or similar arrangements which either of the two Governments has concluded or may conclude in the future."

It is noteworthy that exemptions to unconditional MFN treatment can be found in several trade agreements in South Asia. A case in point is the Trade Agreement between Bangladesh and India. Although Article VI of the Agreement requires the granting of treatment to each

³ As agreed under WTO Hong Kong Ministerial Meeting held in December 2005, India extended duty-free access to all LDCs across 85% of its total tariff lines in 2008 and further extended duty free/preferential market access to 98.2% of its total tariff lines in 2014.

country no less than that accorded to the commerce of any third country, exceptions are made in Article VII, for example, in Para (c), where unconditional MFN treatment is not necessary in the case of customs unions, free trade areas or similar arrangements either of the two Governments have executed or may execute in the future⁴. SAFTA makes a similar exemption in the case of bilateral, plurilateral and multilateral trade agreements through Article 13⁵. Likewise, the Indo-Sri Lanka FTA does not have a provision of unconditional MFN treatment.

Revisit the provision of reciprocal duty-free access to primary products

Article IV grants reciprocal duty-free and quota-free treatment to a mutually agreed list of primary products, including primary agricultural products. This provision constrains Nepal government's ability to protect its agriculture sector from imports from India, where farmers receive a significant amount of subsidies, by imposing tariffs on these products. It was with the aim of having the flexibility of protecting agriculture through tariffs that the Nepal government had managed to set fairly high bound rates (relative to applied rates) for many primary agriculture products in the deal it negotiated for its accession to the World Trade Organization (WTO). Yet it is unable to utilize this policy space on account of Article IV of the treaty. Thus, the treaty must incorporate an exception to the provision for reciprocal duty-free access for primary products by excluding primary agriculture products. Among the items currently listed as eligible for duty-free access, the following should be removed: agriculture, horticulture, floriculture and forest produce; rice pulses flour atta bran and husk; livestock, poultry bird and fish; bees, bee wax and honey; and milk, home-made products of milk and eggs. Even as it negotiates for this amendment, Nepal government should also initiate negotiations with members of the Agreement on South Asian Free Trade Area with a request that it be allowed to bring back select primary agricultural products into

⁴ Article VII of Trade Agreement between India and Bangladesh: The provision of Article VI shall not prevent the grant or continuance of (c) Advantages resulting from any customs union, a free trade area or similar arrangements which either of the two Governments has concluded or may conclude in the future;

⁵ Article-13 of SAFTA: "Notwithstanding the measures as set out in this Agreement its provisions shall not apply in relation to preferences already granted or to be granted by any Contracting State to other Contracting States outside the framework of this Agreement, and to third countries through bilateral, plurilateral and multilateral trade agreements and similar arrangements.

its sensitive lists, goods on which can be shielded from tariff liberalization. Otherwise, even if the Nepal-India Treaty of Trade were amended as suggested here, Indian exporters would still have the option of exporting primary agricultural products to Nepal through the SAFTA route.

Once this amendment is through, it does not mean that Nepal government should start jacking up tariffs on primary agriculture products immediately. But negotiating such an amendment certainly means the government wants to have the option of raising tariffs if and when necessary. India supplies three fourths of Nepal's imports of products on which zero tariffs are applied if imported from India or from China (through Tibet Autonomous Region, China).⁶ With imported paddy and rice contributing about 12-15% of the total supply of paddy and rice in the country, for example, an increase in tariffs on such imports is expected to increase prices, at least in the short run. While pushing for the amendment, Nepal government should prepare a strategy for protecting vulnerable groups from a rise in food prices due to an increase in import prices that could result from tariff hikes. Possible measures include targeted subsidies and checking anticompetitive practices. If anticompetitive practices have, even with zero tariffs, led prices faced by Nepali consumers to significantly exceed the levels that would prevail in a competitive market, checking these practices would moderate or even offset (depending on the gap between current prices and competitive prices) the upward pressure on prices exerted by tariff hikes.

The list of primary products eligible for duty-free access in Article IV must be accompanied by Harmonized System codes to avoid ambiguities regarding which products qualify for duty-free treatment and hence to remove possible arbitrariness in the application of this provision. In similar vein, the list of primary agriculture products that are to be exempt from reciprocal duty-free access must also be specified in terms of HS codes.

⁶ Average value based on calculations on data for the years 2020/21 and 2021/22. On such products, Nepal levies an agriculture reform fee on imports from India and China (if delivered through TAR). Following the amendment, Nepal need not levy the agriculture reform fee.

Simplify 'rules of origin' criteria⁷

India imposes twin criteria to determine eligibility for Nepali manufactured products to qualify for duty-free entry: (i) a change of tariff classification (CTH): a change in classification, at the four-digit level, of the HS required; and (ii) substantial transformation criteria: third country content must not exceed 70% of FOB price (equivalent to 30% domestic value addition). It is to be noted that India's rules of origin for some products originating in LDCs under the SAFTA Agreement are more lenient than in the Nepal-India Trade Treaty.

In view of Nepal's weak industrial base, low productive capacity and supply-side constraints and the preference erosion experienced by Nepali exporters in the Indian market, the multiple rules of origin should be replaced with a single rule based solely on a domestic value-added criterion.

The Protocol to Article V, Para 1 (c) maintains that in cases where only the domestic value-added criterion is fulfilled, preferential treatment could be granted on a case-by-case basis, if sufficient manufacturing process within Nepal could be demonstrated. Thus, one way to deal with rules of origin barrier would be to list the products where exporters have been denied preferential treatment based on non-fulfillment of CTH criteria. However, just having rules of origin criteria based solely on domestic content requirement is much simpler and indicative of maximum preferential treatment accorded to Nepal.

Furthermore, relaxation of the substantial transformation criterion, by increasing maximum third country content requirement from 70% to 75-80% (equivalent to reducing domestic value addition from the current 30% to 20-25%) will also be an important amendment.⁸ This revision will also be compatible with the WTO's provisions for simplified and preferential rules of origin for LDCs. In particular, in the Nairobi Ministerial Conference of the WTO, held in December 2015, members agreed to "adopt a method of calculation based on the value of

⁷ Raihan (2009), which studies the impact of rules of origin and sensitive list on SAFTA trade, finds that 34% of potential exports from Nepal to India are unrealized because of the stringent rules of origin criteria.

⁸ Even the Indo-Sri Lanka FTA allows lower value addition norms for the development of specific sectors of the industry of either Contracting Party through mutual negotiations (Article VII).

non-originating materials”, “consider allowing the use of non-originating materials up to 75% of the final value of the product” and “consider the deduction of any costs associated with the transportation and insurance of inputs from other countries to LDCs.”⁹

Remove all ‘other duties and charges (ODC)’

To ensure predictability and a more conducive environment for trade, all the duties and charges that are levied in addition to customs duties should be removed¹⁰. The ODCs include Education Cess, Higher Education Cess, additional duty of customs (CVD), and Additional Duty (SAD) in the case of India and Agriculture Reform Fee in the case of Nepal¹¹.

Operationalize the provision for mutual recognition of SPS certificates and the capacity building provision

In Para 6 of Protocol to Article II of the treaty, both countries have agreed to grant recognition to the sanitary and phytosanitary certificates (including health certificates) issued by the competent authority of the exporting country with regard to agricultural and food products. This provision was introduced in the 2009 revision of the treaty. Proper implementation of this provision has to be ensured so that conformity assessment measures do not result in duplicate efforts (double testing and certification) and undue burden to Nepali exporters, notably small and medium enterprises. Implementing this provision to grant recognition to testing and certification done by the competent authority of Nepal regarding safety and quality parameters in, to begin with, the products of key interest to Nepal would greatly benefit Nepali exporters. This is important because SPS and technical barriers to trade (TBT) issues, particularly testing and certification, are considered to be

⁹ Preferential Rules of Origin for Least-Developed Countries – Ministerial Decision – WT/MIN(15)/47 – WT/L/917/Add.1

¹⁰ Equivalent internal taxes, anti-dumping duties, countervailing duties, and service fees and charges do not fall under “other duties and charges.”

¹¹ Nepal was eligible for exemption of SAD pre-Goods and Services Tax (GST) regime; however, after the introduction of GST in 2017, SAD that was previously applicable to a lot of products got nullified as it was subsumed by the GST rates. However, some products still attract CVD and SAD. Education Cess and Higher Education Cess are levied on the value of basic customs duty and hence are applicable to only those Nepali exports that attract customs duty. Nepal applies 5% or 9% agricultural reform fee on agricultural imports from India (as of fiscal year 2022/23).

major barriers to Nepali exports of items like tea, cardamom, ginger, and other agricultural and food products.

In cases where Nepal lacks competency for product testing and certification, India's assistance to improve testing capacities for the products of interest to Nepal must be sought and provided, as agreed upon in Para 3 of Protocol to Article I (introduced in the 2009 amendment). The capacity development provision in Para 3 of Protocol to Article 1 is couched in a best-endeavours language. It should be clarified and strengthened with the following amendment: "The Government of India, on request from the Government of Nepal, *shall* assist Nepal to increase its capacity to trade through improvement in technical standards, quarantine and testing facilities and related human resources capacities *so as to conclude Mutual Recognition Agreement (MRA).*" (key suggested amendments italicized).

Address some procedural irritants in exports

In order to address procedural irritants in the export of, for example, pharmaceutical products, vegetables, medicinal and aromatic plants, there is a need to amend Para (4) of Protocol to Article 1 as: "Both Contracting Parties will facilitate cross-border flow of trade through simplification, standardization and harmonization of customs, transport and other trade related procedures, *including inspection, import licensing, certification, registration, and development of border infrastructure.*" (key suggested amendments italicized).

Adapt the provision for relief in excise duty on manufactures produced in small-scale units in Nepal to the GST regime

Para 3 of the Protocol to Article V provides for India granting relief in the application of excise duty on manufactures produced in small-scale units in Nepal to the extent such a relief is provided to such products produced in small-scale units in India. Now that the excise duty has been subsumed under the Goods and Services Tax (GST), introduced in 2017, the provision should be amended to reflect the GST regime. Moreover, the extent to which the existing provision was utilized by Nepali manufacturers should be investigated and measures taken to increase the utilization rate if it is found low.

Remove the time-bound nature of the trade treaty

The treaty has a seven-year period of validity. As amendments can be achieved upon the mutual consent of contracting parties through the Inter-Governmental Committee (IGC), having a perpetual validity could reduce the environment of uncertainty emanating from a limited period of validity. A case in point is the Indo-Sri Lanka FTA which specifies that “This Agreement shall remain in force until either Contracting Party terminates this Agreement by giving six months written notice to the other of its intention to terminate the Agreement.”¹²

Implementation and miscellaneous issues

Explore other preferential schemes to export to India

As mentioned above, India does not impose quantitative restrictions on imports in its global preferential market access scheme for LDCs and its preferential market access scheme for LDC members of SAFTA. Further, cosmetics and perfumes (of a non-Nepali or non-Indian brand) are excluded from duty-free access to the Indian market under the bilateral trade treaty whereas they are not on India’s LDC-specific sensitive list under the SAFTA Agreement. Certain products under the cosmetics and perfumes category get preferential tariff treatment under India’s global preferential market access scheme for LDCs. Nepal should, therefore, explore the option of exporting goods subject to quotas or which are on the sensitive list in the bilateral trade treaty through these two alternative schemes. As of now, when Nepal graduates from the LDC category in 2026, these LDC-specific schemes will not be applicable to Nepal. Still, as the European Union and the United Kingdom have already announced an extension to their LDC-specific duty-free and quota-free market access schemes for three years following graduation, it is quite probable that India will offer a similar extension. As for SAFTA, it has a precedent of continuing with the special and differential treatment granted to LDC members to an ex-LDC member (that is, the Maldives). Hence, exploring the option of exporting through the two LDC-specific schemes of India is worthwhile.

¹² Article XIV.

Anti-dumping duties

Nepali jute products have been subject to anti-dumping duties in India since 2017—the anti-dumping investigation conducted by the Directorate General of Anti-Dumping & Allied Duties in 2016 recommended the imposition of anti-dumping duties of varying amounts on exports of certain jute products (Jute Yarn/Twine, Hessian Fabric, and Sacking Bags) from Nepal, which was extended for another five years as per another recommendation made in 2022. As per WTO rules, it is within a country’s legal rights to impose anti-dumping duties to offset the injuries caused to domestic industries as a result of dumping—when products are exported at a price lower than that in the domestic market or third-country markets, or at less than the production cost.¹³

However, the view in Nepal is that the anti-dumping duty has been applied unjustly on Nepali exports. Nepali jute product manufacturers vehemently deny that they are dumping their products in the Indian market. For instance, trade statistics shows 85 percent of raw jute is imported from India and Nepal's domestic production of jute is only one-third of imports. Nepal Jute Mills Association¹⁴ also points out that Nepali jute product exporters source 40 percent of their raw jute from India, and they also source machinery and parts from India. Furthermore, some issues have been raised about the investigation procedure itself. While WTO rules oblige the importing country to name the supplier or suppliers of the product concerned for the imposition of anti-dumping duties, in this case the investigation authority recommended blanket anti-dumping duties for all producers/exporters.

The five-year extension of the imposition of the anti-dumping duty on Nepali jute products, as recommended in 2022, is also questioned on the grounds that this was done without a rigorous investigation procedure. In addition, the government of India has failed to clearly communicate the validity of the imposition of anti-dumping duties to the jute producers/exporters in Nepal, who express strong reservations about the fairness of the imposition of those duties, as well as the government of Nepal. Hence, this matter has to be amicably resolved in the upcoming negotiations.

¹³ https://www.wto.org/english/thewto_e/glossary_e/dumping_e.htm

¹⁴ Email correspondence with SAWTEE.

Review of the implementation status of Paras 5 and 6 of the Protocol to Article V

These provisions are about providing relief in the application of additional duties other than basic customs duties by India to manufactures produced in large- and medium-scale units in Nepal. The status of implementation of these provisions (e.g., utilization rate by eligible Nepali manufacturers) before and after the introduction of GST should be assessed, and they should be adapted to the GST regime.

Effectively operationalize the provision for joint meeting of local authorities

The Protocol to Article XI provides for joint meetings of local authorities comprising customs officers, quarantine/food test officers, local chambers' representatives, and any other local officials nominated by the respective government, in order to resolve problems arising in the clearance of goods at the land customs stations. At present, the meetings are limited to customs officials and the mandate is not clear. There is a need to enlist the participation of all the relevant agencies, and provide a clear mandate to the joint committee through a term of reference.

Institute a Dispute Settlement Mechanism/Grievance Redressal Mechanism

The treaty does not have a provision for a dispute settlement mechanism. Disputes are generally discussed in the meetings of the Inter-Governmental Committee (IGC), led by the Secretaries in the Ministry of Commerce of the two governments, and the Inter-Governmental Sub-Committee (IGSC), led by the respective Joint Secretaries. Disputes are also raised through diplomatic channels. These are not an effective way to address and settle disputes expeditiously. It is essential to institute a dispute settlement mechanism/grievance redressal mechanism in the treaty.

Other issues

The Indian government should allow Nepali pharmaceutical manufacturers to appoint an agent in India to enable them to export their products. Procedures for the return of defective and damaged products should be simplified. Procedures for temporary exports and imports

should be simplified. A provision or an arrangement is needed to address defaults on payments.

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