India's FTAs and MSMEs (Part II)

India's Free Trade Agreements and Micro, Small and Medium Enterprises

A Primer for MSMEs

This toolkit is designed to help you understand FTA provisions and assess the possible impact on your business.

How to use the Toolkit?

This toolkit is a basic primer intended to initiate the readers into the world of the FTAs-MSMEs interface. It has 3 main sections; each section acts as a building block for latter sections but can also be used chapter by chapter depending on what you are looking for.

- Chapter 1: This chapter will help you gather basic information on FTAs, their types, key features and provisions. It will also show you the impact each provision may have on MSMEs.
- > Chapter 2: This section will provide you with the tools to assess the impact on your business.
- Chapter 3: This section will tell you where you can find more information
- > Chapter 4: If you are worried that your business will be impacted, this section will give you some ideas on what you could do to get your association or government to take into account your concerns.

Introduction

What is 'Trade Policy' and how is it linked to Free Trade Agreements?

If you are an entrepreneur in the Micro, Small and Medium Enterprise sector (MSMEs), the recent shift in India's trade policy from multilateral trade agreement to bilateral free trade agreements (FTAs) could significantly impact your business. Trade policy is an important tool used by the Indian government to determine not only what India should export and import but also to determine who will be the beneficiaries of its trade with other countries. Until about a decade ago. India's international trade policy was largely governed by WTO's multilateral trade framework which obliges its member countries to tariff reduction and restrictive non-tariff barriers but does not eliminate tariffs altogether. In recent years however, India's trade policy is being determined by Free Trade Agreements (FTAs). A Free Trade Agreement aims at total elimination of all tariffs and contains many items that are not part of the rules of the WTO such as changes to regulation in intellectual property, investment, public procurement and competition. FTAs are expected to reduce India's ability to choose policy in the interest of domestic enterprises.

How important are MSMEs for the Indian economy?

MSMEs are enterprises engaged in manufacturing and services with investment in plant and machinery below 25 lakhs and Rs 10 lakhs respectively. There are about 28.5 million MSMEs in India providing employment to more than 60 million people, mostly from the poor and disadvantaged sections of our society. Clearly, MSMEs play an important role in India's economic and social arena.

Why should FTAs matter to MSMEs?

If India signs an FTA, India's trade including trade with MSMEs will be subject to severe trade related competition and conditionality emerging out of various chapter and provisions of the FTA agreements. Out of 28.5 million MSMEs over 25 million are micro enterprises which have extremely limited capacity to compete against the large enterprises from developed countries. The million dollar question then remains: how will MSMEs cope with this complete liberalisation of trade? Will it be an opportunity or a threat? MSMEs contribute about 45% to India's industrial output and 40% to its exports. It is therefore extremely important that any major trade policy-making in India should keep in mind the trade prospects of MSMEs in both domestic and export markets.

Why have this Toolkit?

This toolkit is designed to help you understand FTA provisions and assess the possible impact on your business. FTAs may have an impact not only on export markets but also on the domestic market. And because draft texts and impact assessment studies are not made available, knowledge and awareness about FTA provisions and their impact remain highly inadequate among stakeholders. This toolkit will help you to bridge this gap.



Chapter 1: Free Trade Agreements: Types, Features, Provisions, and Impacts

What type of FTAs is India negotiating?

In the past, India signed FTAs which covered trade only in goods (see for example: the FTA with Sri Lanka). However, in recent years, India is signing and negotiating FTAs which are more comprehensive treaties covering trade not only in goods but also in services, as well as investment, TRIPS plus intellectual property rights (IPRs), and even public procurement and competition policy. FTAs with Japan, Malaysia, and South Korea for example are of this variety. Those currently under negotiation with the EU and EFTA are also comprehensive. Further, the Indian government has already begun high level talks envisaging FTAs with New Zealand, Australia and Canada and is perhaps envisaging FTAs with the USA.

What are the key features of the Free Trade Agreements?

The following are the key features of a Free Trade Agreement:

- > Elimination of tariff barriers (import and export duties) on 85 to 90% of goods.
- > The trading partners must be treated equally even if they are not equal in terms of socio-economic development indictors.
- Partner countries cannot have discriminating trade policy instruments such as taxes, subsidies, regulations, or laws) favouring their own companies over foreign companies.
- > They also include chapters covering services, investments, public procurement and competition policy. All these chapters invariably influence each other and the aggregate impact on the industries could be much deeper

Under FTAs, markets are supposed to be fully opened up and foreigners and locals would be treated equally. Unlike in the WTO, under FTAs, developing countries will not be technically entitled to concessions given under the 'special and differential treatment' (S&DT) and FTA partners are supposed to engage in fully reciprocal trade, i.e. give and take of equal magnitude.

What are the key chapters in the FTAs and what are the provisions in each chapter?

Under FTAs, the key trade issues can be classified into two categories: Good Trade Issues and Non-Goods Trade Issues.

In **goods trade**, there are mainly six issues: (I) Import Duties, (II) Export measures, (III) Non-tariff measures, (IV) rules of Origin, (V) Anti-concentration clause and (VI) Sectorals (Zero for Zero reduction).

Here is a brief explanation of the above six issues under Goods Trade in FTAs and their provisions and how FTAs will significantly affect Indian trade and industries, especially the MSME sector.

(I) Import Duties: Duty, tariff or tax that is imposed by the government on the goods entering the border of a nation is called import duty. The government uses "import duty" as a policy instrument to protect and promote its indigenous industry producing substitutes of imported goods. Currently under the WTO regime, the industrial goods entering India face on an average, a maximum duty of 34.4% (bound tariff) and actual duty (applied tariff) on an average is 10.1%. FTAs require India to reduce applied rates to zero on at least 85% to 95% of its products.

The impact of this on the MSMEs could be the following:

Increased import competition due to tariff elimination would be a big threat for MSMEs. According to the SIDBI survey, 71% of the surveyed MSMEs found that their sales due to imports declined by 26-50 percent. Even worse, under FTAs, there are hardly any safeguards available to protect your economy against the import surge. (II) Export Taxes: Governments levy export taxes on exports of certain goods, especially raw materials to ensure cheaper raw material supply to industries which are growing and important for the economy. Currently India levies export taxes of 10% to 25% on tanned and non-tanned hides, skins and leathers including vegetable dyed leather used by the saddlery industry. India also imposes export taxes on a number of other raw materials to help ensure that these resources are available to domestic industry at cheaper cost. Some countries, especially developed countries, notably the EU, want export taxes to be completely removed in partner countries under FTAs.

The impact of this on the MSMEs could be the following:

- > If India is forced to remove existing export taxes as a FTA requirement on a number of products including raw leather and wood, MSMEs could face severe shortage of raw material and they will no longer be able trade competitively. Livelihoods of millions of people dependent on these MSMEs will be adversely affected. For example, in furniture sector, Malaysia imposes export taxes on raw timber which keep their inputs relatively cheap and hence they remain competitive in furniture trade. Kenya too revived its leather industry by imposing 40 per cent export duty on raw hides and skins.
- (III) Non-Tariff Measures/Barriers: All measures other than normal tariffs, , namely trade procedures, regulations, standards, licensing systems etc. are called Non-Tariff Measures (NTMs). Those NTMs that cannot be justified under WTO law are generally termed as Non Tariff Barriers (NTBs). As NTMs, certain standards are imposed on foreign imports on grounds of quality, health, food safety etc. Developed countries have been especially accused of using high NTBs to block imports from developing countries, even through FTAs. They also impose labour and environment standards through FTAs which countries like India sees, as additional NTBs. MSMEs generally find it extremely difficult to meet all these high standards because meeting these quality standards requires huge investment. Also, compliance requirement and procedures are often very complicated, time consuming and costly. FTAs sometimes bring in higher standards, and cannot reduce standards per se. However, sometimes mutual recognition of

each others' standards and recognition/certification processes through Mutual Recognition Agreements (MRAs) may be possible through FTAs.

The impact on MSMEs could be the following:

- By agreeing to stringent NTM/NTBs in FTAs, it would become compulsory for MSME exporters to meet high health, safety, labour and environment standards for exports to developed country markets. Majority of MSMEs in India neither have the capacity nor the facilities to match the high standards of developed countries and cannot hope to gain from FTAs also because these do not ensure lower standards or easier processes of quality certification. Consequently, MSMEs exports may face very high rate of rejection in importing countries. Some development analysts feel that labour and environment standards must be pursued domestically, committing to these in trade agreements is an invasion of India's domestic policy choice.
- (IV) Rules of Origin (ROO): Essentially, the "Rules of Origin" mean that for a product to be exported to a FTA partner country, the product must have enough local content, as specified by the ROO to qualify for preferential duty (zero or lower than the general duty). The difference between the value of the final good and the costs of the imported inputs constitutes the share of local content. Generally, manufactured products undergo several stages of processing before it turns into the final product. Each stage requires inputs and processing which may be sourced from abroad and at each stage some value is added to the overall value of the product. To determine whether a good qualifies under ROO for preferential tariffs or not, the most common rule requires that the share of local content must be a certain minimum percentage, usually about 30-60%. ROO specifications vary from FTA to FTA depending on the interest of the partner countries. Developed countries usually want strict ROO. These stricter ROO may impact Indian MSMEs.

The impact on MSMEs could be the following

> The Indian MSME often want to import cheap inputs as intermediate goods from neighbouring countries like China and MSME products often have huge import content. Due to stricter ROO, MSMEs will not be able to import at cheaper rates these intermediate goods and their products will no longer qualify for exports and additional market access.

- Moreover, As ROO specifications varying from country to country, it will be difficult for micro and small enterprises to calculate the local content and to meet the cumbersome procedural requirement in obtaining the ROO certificate.
- > As an export promotion measure, under Duty drawback scheme Indian MSMEs are provided reimbursement of import duty, if the import is meant for manufacturing of export products. This may encourage higher import content but then these products will come up against the ROO barrier and will not be able to export to FTA partners with strict ROO.
- (V) Anti-concentration clause: There are certain industries which are sensitive such as where MSMEs are dominant and these would benefit from protection through a sensitive list where there is no obligation to cut tariffs. However, an anti-concentration clause allows only some products (20% of the tariff lines) in the sensitive list and not the whole sector. As a consequence, India would lose its flexibility to protect whole sectors and FTA partners would gain market access to all sectors. Many countries, especially developed countries such as the EU, want to include the anti-concentration clause in their FTAs.

This may impact the MSMEs as following:

- > The Anti-Concentration Clause restricts the policy space of governments. The Clause may be problematic for the auto industry, textile & garments and fisheries. Most of these industries are in the MSME sector. Also, it could be a problem for gender sensitive products i.e. products where women workers are employed in large numbers. Women's employment opportunities in MSMEs will be severely affected if such a product line under food processing industry is left out of the sensitive list.
- (VI) **Sectorals** (Zero for Zero reduction): Under the WTO's proposal on Sectorals, trading partners have to reduce import duty to zero in some sectors with immediate effect on a voluntary basis. This is a relatively new and much contested proposal even in the WTO which may be replicated in some FTAs.FTAs reduce duties to zero over time but India may face pressure to remove duties in some sectors with immediate effect.

Sectorals may impact the MSMEs as following:

Due to inclusion of the Sectorals clause in FTAs, import duty in both the partner countries may become zero with immediate effect in some important and sensitive industry segments like textiles

In FTAs, under the **non-goods trade issues**, there are 4 key issues, namely (I) Intellectual Property Rights policy, (II), Investment policy, (III) Public Procurement Policy and (IV) Competition policy.

A brief explanation of each and the impact they may have on MSMEs are given below.

- Intellectual Property Rights (IPRs): Under WTO's Trade Related Intellectual Property Rights (TRIPS), member countries are obliged to adhere to minimum harmonised standards for protection of IPRs such as patents, geographical indications (Gls), trademark, industrial design rights, copyright etc. TRIPS however provides some flexibilities to developing countries in special circumstances. FTAs deny these flexibilities and try to impose rules making the IPR regime much stricter than TRIPS. In FTAs, developed countries such as the EU, USA, Japan, and Switzerland want to impose on India such IPR commitments that go beyond TRIPS commitments. India has refused to commit beyond TRIPS in its concluded FTAs but is still negotiating on TRIPS plus with the EU and Switzerland (part of EFTA). Stricter IPR regime may impact the Indian MSMEs as following:
- > For small enterprises in particular, the stricter IPR regime will create some major problems. Only 1.65% registered SMEs in the world have patents. This is probably because most MSMEs lack the resources and capability to do research and development and acquire advanced technologies. Smaller producers will be often pushed out by bigger companies, especially multinationals, which can get IP rights such as patents much more easily as they have huge resources to spend on R&D and patent applications. The stricter IPR regime under FTAs will in effect give developed countries considerable control over critical resources in developing economies. It also threatens products which are based on traditional knowledge such as herbal medicines.
- (II) Investment Policy: A country's investment policy determines to a large extent the nature, magnitude and pace of investment, along with ownership pattern of domestic enterprises. Because of the obvious sensitivity of this issue, full opening up for foreign direct investment in all segments of the

economy was kept out of the WTO. However, 'investment' has been included in the FTAs. According to the investment chapter in FTAs, foreign investors will be treated equal to domestic investors. Also, foreign investors can enter and operate largely without constraints and conditions they were subjected to until now. In addition, foreign investors can sue governments directly if their rights or profits are infringed upon. Under FTAs, foreign investors cannot be asked to have Indian board members, invest a minimum amount, have local labour, or for technology transfer either. These are called performance requirements. The Indo-Japan FTA contains in its investment chapter most of these elements. The impact on MSMEs could be the following:

- In most industries in India, foreign direct investment is already allowed (given certain restrictions or caps) so additional FDI may not necessarily be forthcoming after opening up of "Investment" in FTAs. But, after an FTA, wholly foreign owned enterprises may be set up in many more areas without any performance requirements and it could also lead to mergers and acquisitions in certain MSME segments. Small entrepreneurs and small business could be taken over by the large enterprises. In the pharmaceutical industry, for example, such acquisitions are already taking place.
- (III) Public Procurement: Public procurement is the procurement of goods and services on behalf of a public authority, such as a government agency. Public procurement accounts for 10 to 15% of GDP in developed countries, and up to 20% in developing countries. Many developed countries, for example the EU, are very keen to get 'market access' to the significant government purchases and procurement market in other countries, especially big countries like India. India uses government procurement as a development policy tool to address economic and social inequalities by giving certain preferences to vulnerable groups such as MSMEs, women's groups, village enterprises, minorities, backward communities.
- > If the government gives market access to India's public procurement market, foreign companies will have a legal right to be treated equally with domestic companies under the 'national treatment' clause when they apply for public procurement contracts. If this happens, Indian MSMEs which supply many products to the government (such as leather, plastic and metal products) will have to compete with foreign companies. This is likely to result in MSMEs losing out in terms of market share

- for their products. India is not keen to include its government purchase (GP) market under FTAs especially when it is not likely to get much access into developed country procurement markets where a host of NTBs block foreign suppliers. Even though the Indian government may not have agreed to directly give away its 'public procurement market' to foreign entities, indirect pressure of the FTA regime is clearly evident. For example, in the pharmaceutical segment, the minimum turnover required to be considered as a supplier is now 25 crores in some states and at the Centre. This has been automatically eliminating MSMEs from this segment of government purchase.
- (IV) Competition Policy: Competition Policy was also kept out of the WTO because of its critical role from a development perspective. However, developed countries now demand that competition policy should be included in FTAs and companies should be given equal treatment regardless of their nationality. Until now, India has not made major concessions under this chapter. For example, in its FTA with Japan, though non-discrimination is included, it is not enforceable. But the EU, for example, wants a stronger competition policy in conformity with its own domestic competition policy.
- If 'Competition Policy' clause in is included in FTAs and the Indian Government agrees to adhere to a high and enforceable standard of competition, Government of India cannot discriminate between foreign enterprise and Indian enterprises, and it would be extremely difficult for her to pursue some of her preferential policies such as in public procurement to Indian MSMEs. Allowing free competition often allows smaller enterprises to be eaten up by larger ones. The history of competition policy in most countries has shown that it has led to mergers and acquisitions of smaller companies in a big way. Competition Policy often prevents state aid and limits the activities of state trading corporations. Competition policy in FTAs will lead to reduced policy choices for the Indian government. The Indian government may not be able to treat Indian MSMEs preferentially over bigger and foreign industries and also may not be able to proffer development schemes for the Indian MSMES.



Chapter 2: How to Assess the Impact of FTAs on your Enterprise?

The goods trade and non-goods trade issues contained in FTAs significantly impact India's trade prospects, and therefore MSMEs' economic future. MSMEs, and not only those which are engaged in exports and imports, but even those which trade only domestically need to be aware and alert of the policy changes in international trade rules that the Indian government is signing up to. Hence you will need to keep track of developments on both MSMEs and FTA fronts (see page 8 on 'where to access more information').

How you can access the impact on your enterprise

You can assess the impact FTAs may have on your enterprise by seeking answers to questions given below.

The box at the end of this table on page 8 tells you where you can access more information that will help you answer these questions. The accompanying report (Part I) also explains in more detail the different sections of this Primer, strategic options and gives you a short glossary of terms.

Good Trade Issue 1. Actual Import Duty will be reduced to Zero

Leading Questions for MSMEs

With which countries is India negotiating with or has signed an FTA? The product that I am manufacturing, is also being produced in these countries? Has its import gone up? What is the current duty on my product?

Is my product on the sensitive list in the already signed FTAs? Do I qualify the criterion for being included in the sensitive list?

Implication: If yes, I face no threat from import duty cuts.

- > Are duties being reduced to zero in India or partner countries on my product and by when?
- > Am I competitive to FTA partners, price and quality wise?
- > Will I benefit if duties are reduced on imports? Am I importing inputs from FTA partners?
- > What is the current duty on my product in FTA country? Will duties be reduced on my exports to FTA partners? By how much?
- > Is my product on the partners' sensitive list (already signed FTAs)?

Good Trade Issue 2: In FTAs, Export duties will be reduced Zero. Quantitative restriction is generally not allowed.

Leading Questions for MSMEs	Implications for MSMEs
Do I use Indian inputs which have export taxes?	If export taxes are removed, export of this product will go up and I will face shortage of this product. The price of this product may go up and my cost of manufacturing will also go up. It will be a huge loss.
Do I use foreign inputs which have export taxes?	I can get access to cheaper raw material from other FTA partner countries.

Good Trade Issue 3: More stringent Non-Tariff Barriers (NTBs) and Technical Barriers to Trade in FTAs

Is it affordable for us to meet process requirements?	For MSMEs, It would consume a lot of time , effort and money.
Is there Scope for bilateral negotiation for mutual recognition on NTB & TBTs?	Theoretically yes, but in practice they do not come down.
If Indian NTBs go up, can it protect my product? (competitor has lower quality product)	Yes, MSMEs should ask the Indian Government to use India's own NTBs to protect MSME products if having to reduce/remove import duties?
If Indian NTBs go up, can I meet those standards?	Most likely MSMEs will not be able to meet those standards.

Goods Trade Issue 4: Strong Rules of Origin

Leading Questions for MSMEs	Implications
Do I import raw material/inputs/intermediate goods?	
What is the share of imported goods in the total value of my product?	If it more than 65% or so, my export in partner countries will not be allowed.
Can I meet the ROO in my product for relevant FTAs? Is there any product specific rule on my product in the current FTAs?	If Indian ROO is strict enough, then it may block imports from third countries. If not other country products may come into India.

Non-Goods Trade Issue in FTAs 1: Labour and environment standards in North-South FTAs	
Leading Questions	Implications
What standards do I need to conform to in terms of Labour and environment standards to sell to an FTA partner?	May be good for workers but controversial
Can I meet the required standards of an FTA partner?	Compliance cost are high

Some more leading questions on this issue could be the following:

- > What is the cost implication of upgrading to meet FTA partners' standards?
- > How much additional and actual market access will I get if I upgrade standards to conform to partners' standards?
- > Is the FTA bringing in easier process requirements (certificates etc)
- > Is the FTA then reducing costs for meeting these standards?
- > Will workers be benefitted if I raise standards? If yes, how?
- > Will the raising of standards increase productive efficiency?

Non-Goods Trade Issues 2: Investment Chapter in FTAs

Leading Questions	Implications for MSMEs
Will I benefit from foreign investment in my industry?	Will it wipe out local MSME entrepreneurs?
If fully foreign funded industries (from FTA partner countries) were set up, will I be able to compete?	Does it increase competition for existing MSMEs?
Will the technology used by foreign companies be more labour intensive or labout displaying?	Does it impact labour supply and terms of labour

Some more leading question on the issue could be as following:

- > Will I compete for labourers with Foreign owned companies (if they offer higher wages)
- > If investment is allowed in FTA partner countries, am I going to invest there? Do I have the capacity?
- > If I invest abroad, do I want investor protection through the FTAs?
- > If a protection mechanism exists, will I have the resources to take FTA partner countries' governments to court?

Non-Goods Trade Issue 3: Public Procurement

A few leading questions on the issue is suggested below:

- > Do I get any special concession in Indian government's purchases?
- > Do I want special access to the Indian government's purchases in the future?
- > Am I able to compete with foreign bidders (especially those from FTA partners) for government purchase contracts?
- > If I currently see to the government, what percentage of my total sale does this contribute?
- > Do I sell to another larger enterprise which bids for government purchase contracts? And if that enterprise loses contract while competing with foreign bidders, will I lose my market too?
- > If PP was opened up in FTAs, can I sell to the partner country governments?
- > Will I be able to match quality standards in FTA partner country's government procurement?

Non-Goods Trade Issue 4: Stricter IPR regime in FTAs

Leading Questions Implications for MSMEs > Have I applied for or registered any intellectual property instruments? E.g. Geographical Indications, Patents,

- Trademark, Collective Mark etc.
- > Have I ever faced any IP barrier while selling or exporting my product? (e.g. someone else had a patent)
- > If a producer from an FTA partner country had an IP (e.g. GI, patent) on a similar product to what I sell, will it adversely affect my business?

Non-Goods Trade Issue 5: Dispute Settlement Mechanism in FTAs

- > Have I ever needed to resolve disputes related to trade issues? Which mechanism have I used?
- > Will the FTA give me an easier DS mechanism?



Chapter 3: Where to Access more Information on FTAs and MSMEs?

4

Chapter 4 : How and whom to influence in the government to make your voices heard?

Access to Information about FTAs and MSMEs

Ministry of Commerce and Industry, GOI

http://commerce.nic.in/trade/international_ta.asp?id=2&trade=i

Website exclusively on FTAs

http://www.bilaterals.org/

World Trade Organization(WTO)

http://www.wto.org/english/tratop_e/region_e/region e.htm

WTO cell of Indian Institute of Foreign Trade

http://wtocentre.iift.ac.in

Information on Non-Tariff Measures(NTMs)

http://commerce.nic.in/trade/international_ntm. asp?id=4&trade=i

Information on Technical Barriers to Trade(TBTs) and Sanitary and Phytosanitary Measures(SPS)

http://commerce.nic.in/trade/TBTSPS.asp?id=5&trade=i

Information on IPRs

http://dipp.nic.in/intellectual property dipp.htm

Information on investment and industrial policy

http://dipp.nic.in/policy_dipp.htm

For data on India's trade

http://commerce.nic.in/tradestats/indiatrade.asp

For data on trade and commerce

http://dgft.gov.in/

Where can you to access more information about MSMEs?

Website of Ministry of MSME,

http://msme.gov.in/msme_admin.htm

Information on central policy and schemes

http://dcmsme.gov.in/

Information on MSMEs in Uttar Pradesh

http://ssi.up.nic.in/

What to do if you are concerned about FTAs

- > Go through section 2 on "How to assess the impact on your MSME"
- If you are worried that a FTA might impact your sector, raise the issue with other MSMEs and your association
- > Get your association to submit your concerns on the issue to the relevant government representatives
- > Ask your association to press for an impact assessment

Some relevant offices you should think of contacting:

Prime Minister, Prime Minister's Office, GOI

Fax: 011-23016857/9545 Tel: 011 2301 8939

Chairman, Standing Committee on Commerce, Rajya Sabha

Email: rsc-comm@sansad.nic.in Tel: 011 23034036

Minister, Ministry of Commerce and Industry (MOCI), GOI

cim@nic.in

Email: Fax: 011-23062947

Minister of State, Ministry of Commerce and Industry, GOI

Fax: 011-23062321

Secretary, Department of Commerce, MOCI

Email: csoffice@nic.in Fax: 011-23061796

Secretary, Department of Industrial Policy and Promotion, MOCI

Email: rp-singh@nic.in Fax: 011-23061598

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Author: Kumar Gautam and Ranja Sengupta

Printed by: InditeGlobal Pvt Ltd.

For More Information: msme.fta@gmail.com, ranja.sengupta@gmail.com, kmrgautam@gmail.com

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