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U.S-India Relations: Democratic Partners of Economic Opportunity

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Mr. Chairman, Mr. Ranking Member, thank you for the opportunity to testify today before the Committee on "U.S.-India Relations: Democratic Partners of Economic Opportunity." I am Sadanand Dhume, a resident fellow at the American Enterprise Institute, a non-profit, non-partisan public policy research organization based in Washington, DC. My comments today are my own and do not necessarily reflect the views of AEI.

Over the past two decades, both Democratic and Republican administrations, boosted by bipartisan support in Congress, have recognized the importance of building strong ties with India. The world's most populous democracy occupies a pivotal place in Asia, sandwiched between a rising China and the turmoil of Pakistan and Afghanistan. U.S. hopes for fostering peace and prosperity in Asia rest in no small measure on deepening the U.S.-India relationship.

For the most part, however, economic ties between the two countries have not kept pace with a growing strategic convergence. With an annual output of $2 trillion, India is the ninth largest economy in the world. In purchasing power parity terms it is even larger—a $7.4 trillion economy, or the world's third-largest. Yet, in 2015, India was only the U.S.'s tenth largest trading partner in goods, ranked below smaller economies such as Taiwan and South Korea. Trade in goods amounted to $66.3 billion. Trade in goods and services combined came to $107 billion.

Though India's economy is large in absolute terms, it has so far failed to fully live up to its potential. Per capita income of $5,700 (in PPP terms) is less than half that of China, though both countries had similar levels of per capita income barely 35 years ago. With a median age of 27, India is one of the youngest large countries in the world. In order to provide jobs to the 12 million people who enter the workforce each year, New Delhi will have to significantly deepen an economic reform program first embarked upon 25 years ago, but that has lost steam over the past decade.

The U.S. has an interest in India emerging as a prosperous, market-oriented democracy and a strong American trading partner fully integrated into the global economy. These twin goals should anchor U.S. economic policy toward India.

Key policy recommendations:

- *Asia-Pacific Economic Cooperation:* Back India for full membership in APEC as a step toward eventual inclusion in the Trans-Pacific Partnership.

- *Bilateral Investment Treaty (BIT):* Negotiate a high-quality BIT as a stepping stone toward a free trade agreement.

- *Focus on States:* Recognize a trend towards greater federalism in the Indian economy and deepen relations with the fastest-industrializing states.

- *Champion free market principles:* Instead of focusing solely on specific firms or areas of the economy, the U.S. should broadly support the principles of free enterprise that will allow India to unlock its economic potential.

Background:

India's tryst with socialism. Between independence in 1947 and the advent of economic reforms in 1991, India was one of Asia's worst performing economies. Mistrustful of both free enterprise and trade, India's rulers embraced autarky and state planning. Over time, the country's economy became synonymous with the infamous license-permit raj, where bureaucrats made decisions on factory output, and businessmen needed to worry more about whimsical government officials than about consumers.

In the first three decades after independence (1947-77), despite a low base, the Indian economy grew at an anemic annual average of 3.5 percent. In 1964, the average Indian was about three-fourths as rich as the average South Korean. By 1984, the average South Korean was four times richer than the average Indian.

In 1991, faced with a balance of payments crisis, India finally embarked upon economic reforms. It scrapped industrial licensing, freed imports and exports, slashed trade tariffs, and made room for the private sector in areas once monopolized by government. The economy immediately boomed.

Over the next 13 years, India's reform program deepened, albeit in fits and starts. A new telecom policy led to India's mobile phone revolution. India currently has 1 billion mobile phone subscribers, the second highest number in the world. Competitive private firms have changed the face of Indian telecoms and aviation, and have made deep inroads in banking.

Between 1991 and 2011, the Indian economy grew on average at 6.7 percent per year. However, the reform process lost steam after 2004, when a left-of-center government took power. Though the economy continued to grow—buoyed by healthy global conditions and reforms unfurled before 2004—ultimately the lack of fresh reforms caught up with India. According to the World Bank, growth fell from a high of 10.3 percent in 2010 to 5.1 percent in 2012. By the end of 2013, with the stock market falling and the rupee hitting historic lows against the dollar, India had come to be seen as one of the world's "fragile five" economies.

The rise of Narendra Modi. The election of Narendra Modi as prime minister in 2014, with the first single party electoral majority in 30 years, raised hopes that India would return emphatically to the path of economic reform. On the campaign trail, Modi painted his vision for the economy through slogans such as: "minimum government, maximum governance," "red carpet, not red tape," and "the government has no business being in business."

Modi's record as the dynamic and business-friendly chief minister (the Indian equivalent of governor) of the industrialized western state of Gujarat (2001-14) also raised hopes among many investors and commentators of the kind of far-reaching reforms that had eluded India over the past decade.

So far, the Modi government's record has been mixed. It has done its best to roll out a red carpet for investors, with the prime minister himself acting as India's chief pitchman. Foreign investment norms have been eased in, among other areas, defense, insurance and food processing. Between May 2014 and December 2015, foreign direct investment in India rose 33 percent to $64 billion compared to $48 billion in the 20 months before Modi's election. Several high profile firms, including Taiwan's Foxconn and South Korea's Posco have pledged billions of dollars of fresh investment in India. Large U.S. investors include General Electric, General Motors, Uber and Oracle.

The International Monetary Fund expects India's GDP to grow at 7.5 percent this year, which would make it the world's fastest growing major economy. The government also intends to boost infrastructure spending to $32 billion dollars this year, a 22.5 percent increase from the previous year, in order to upgrade India's roads, ports and railways. Despite stepped-up government spending, Finance Minister Arun Jaitley expects to keep India's fiscal deficit in check at a reasonable 3.5 percent of GDP next year. The government also hopes to end harassment by tax officials by simplifying rules. This is part of a larger effort to improve India's Ease of Doing Business ranking, which despite government efforts to improve it, is currently an unimpressive 130 of 189 countries surveyed by the World Bank.

However, in terms of deep structural reform, the government has either been stymied by the opposition or has itself preferred caution to boldness. Thanks to opposition in the indirectly elected upper house of Parliament, a proposed goods and services tax to stitch India into a common market won't be rolled out this April as planned. The opposition has also forced the government to retreat on a proposal to ease land-acquisition norms for industry.

Labor law reform—in effect making it easier for firms to lay off workers during a downturn—has been shunted to the states, but only a handful of them appear interested in pursuing them seriously. A proposed privatization program has stalled. Though the government says it remains committed to privatization, the prime minister has also suggested that he can stem the rot in state-owned companies simply by picking the right managers.

Despite having a comfortable majority in the lower house of Parliament, the Modi government has done nothing to reverse the previous government's worst laws, like an unpopular retroactive tax. Also in force is a government directive compelling companies to channel some of their profits toward social objectives such as reducing child mortality and combating AIDS. In reality, politicians use the provision to "encourage" businessmen to fund their favorite boondoggles.

Instead of winding up the previous government's flagship make-work program—a notoriously leaky rural job guarantee that wasted billions of dollars—the Modi government has increased its funding to a record level.

C**onstraints on economic reform.** Despite his sweeping electoral victory two years ago, Modi faces massive challenges in pushing a reform agenda. To begin with, the ruling Bharatiya Janata Party (BJP) and its allies control only 63 of 245 seats in the indirectly elected upper house of Parliament. Analysts expect the ruling alliance's numbers to rise to around 72 by the end of the year, but this will still leave it well short of a majority in the upper house.

Moreover, the BJP and its allies only control 11 of India's 29 states. An ambitious devolution program transferring more resources to the states, as well as the rise of powerful regional political parties, ensure that many of the most important economic decisions are made in state capitals, and not in New Delhi.

Despite India's impressive economic gains over the past 25 years, in many ways the country's intellectual and political climate remain hostile to reforms. Modi's BJP has lost two important state elections since February of last year. In both cases, the winning regional party accused Modi of caring more about wealthy businessmen than about the poor. Much of the media too subscribes to the (inaccurate) view that encouraging business and investment signals callousness toward the poor. Similarly, outside of a handful of commentators, there is no obvious constituency in India for free trade.

Finally, though India has been a major beneficiary from lower oil prices—it imports about 80 percent of its oil—uncertainty about the global economy, both a slowing China and a stagnant Europe, have helped put policymakers in New Delhi in a defensive crouch.

What the U.S. can do:

From an economic perspective, the twin goals of the U.S. are straightforward. Washington should continue to encourage the emergence of India as a prosperous and strong democracy that acts as a stabilizing force in the region and beyond. At the same time, the U.S. needs to deepen trade ties with India with the strategic goal of remaining India's largest single trading partner taking into account both goods and services.

In terms of policy options, the U.S. has little ability to influence the economic course India chooses. U.S. officials and business leaders can make the case for economic reforms, but the reason many desired reforms have been spoken of for more than a decade without meaningful progress is that they represent difficult political choices.

Regardless of party affiliation, Indian politicians tend to think twice about rolling back expensive subsidies on food and fertilizer or privatizing loss-making state-owned firms. Such measures cost votes. No foreign country is in a position to nudge Indian policymakers on such sensitive issues. Indeed, even the suggestion of doing so would likely provoke an immediate backlash among sections of India's fiercely nationalistic media.

However, while acknowledging its limited role in influencing the pace of economic reform in India, the U.S. can still strive to both better India's economic prospects and boost commercial ties between the two countries.

Asia-Pacific Economic Cooperation. *Back India for full membership in APEC as a step toward eventual inclusion in the Trans-Pacific Partnership.*

Founded in 1989, the 21-nation APEC is East Asia's broadest economic grouping and the world's largest trading bloc, accounting for three billion consumers and 44 percent of global trade. In 2010, a decade-long moratorium on new members expired, opening the door for India, whose initial application for membership in 1991 was rejected.

The U.S. has welcomed India's interest in joining APEC, but has not backed formal membership. Publicly backing India's candidacy for APEC membership would echo a broad U.S. policy that supports India's rise as a responsible global power. Washington has already supported Indian membership in the G-20, four multilateral nonproliferation regimes, and an expanded United Nations Security Council. In addition, India is already a full member of the East Asian Summit and the ASEAN Regional Forum, and is a dialogue partner with ASEAN.

The case against backing India's entry into APEC hinges on its notoriously obstreperous trade negotiators, who some of their American counterparts hold responsible for helping create a stalemate at the World Trade Organization. They fear that admitting India into APEC will hurt the group's capacity for consensus building and dilute the quality of its trade agreements.

Although these concerns are legitimate, backing India's APEC membership is a low-risk gambit for the United States and carries potentially large rewards. At worst, India complicates the workings of an already unwieldy body that concludes nonbinding agreements among members. At best, India uses APEC membership as training wheels to prepare it for the more ambitious Trans-Pacific Partnership (TPP), embraces the best practices APEC espouses, invigorates the grouping with new energy, and integrates itself more fully into the global economy.

Bilateral Investment Treaty. *Negotiate a high-quality BIT as a stepping stone toward a free trade agreement.*

A U.S.-India BIT will signal renewed purpose in bilateral economic relations, level the playing field for U.S. firms in India, and pave the way for a more ambitious free trade agreement. A BIT with India was first proposed by the George W. Bush administration, but progress on it has long languished in both countries. Both countries support the idea of a U.S.-India investment treaty, but in practice progress toward it has been slow.

Less comprehensive than a free trade agreement, a BIT nonetheless facilitates foreign investment by ensuring so-called national treatment of foreign firms, limiting government expropriation, and providing for binding arbitration between investors and governments. Currently, the U.S. has operational BITs with over 40 countries, including Bangladesh and Sri Lanka in South Asia.

Some supporters of the U.S.-India relationship regard a BIT as trivial given the size of the U.S. and Indian economies, and the scale of ambition a “strategic partnership” between the two countries suggests. This is true, but negotiating a BIT remains a good idea, not as an end in itself but as a significant marker toward the broader—but at this point politically unfeasible—goal of an FTA. A BIT will not by itself transform U.S.-India trade ties, but the inability to negotiate one despite years of trying acts as a damper on the two countries making meaningful progress on trade.

Focus on States. *Recognize a trend towards greater federalism in the Indian economy and deepen relations with the fastest industrializing states.*

As India grows richer and more urban, it is also growing more federal. Last year, the government sharply upped the share of states in federal taxes to 42 percent. As Morgan Stanley’s Ruchir Sharma puts it, after a long period of highly centralized rule, India “is rediscovering its natural fabric as a nation of strong regions.”

The U.S. should seize the opportunity to focus on India’s most entrepreneurial states on the western and southern coasts. U.S. success with federalism, and in building some of the world’s greatest cities from scratch, can be particularly helpful to India’s fast-urbanizing states. Moreover, the Indian-American diaspora, disproportionately drawn from economically dynamic regions such as Gujarat and Andhra Pradesh, offers a natural bridge toward closer subnational business ties. Reliable estimates are difficult to come by, but on the high side some suggest that about half of Indian-Americans trace their origin to Gujarat.

Devolution in India means powerful state-level satraps will exert greater influence on the federal government in New Delhi and at the same time, carve out more decision-making power for themselves in the country’s 29 states, many of which are more populous than most countries. A more federal and urban India will likely show greater entrepreneurial dynamism and produce greater prosperity faster than before. High-performing states also offer India the best opportunity to reform an overly populist political culture that holds the country back. Politicians such as Gujarat’s Narendra Modi (as chief minister), Andhra Pradesh’s N. Chandrababu Naidu, and Odisha’s Naveen Patnaik, have proved that even in India business-friendly leaders can be elected.

Champion free market principles. Instead of focusing solely on specific firms or areas of the economy, the U.S. should broadly support the principles of free enterprise that will allow India to unlock its economic potential.

If economic relations between the U.S. and India are to avoid getting bogged down in minutiae, and are instead to serve U.S. strategic goals in Asia, the U.S. should encourage India to become a more competitive, market-oriented economy for its own sake, even if specific reforms offer no clear payoff for U.S. firms. For instance, India needs better roads, but given the lack of U.S. competitiveness in this area they are unlikely to be built by American firms, though they may at times be built with American equipment.

At the same time, the U.S. should aim to remain India's top trade partner. Last year, Secretary of State John Kerry reiterated the goal of multiplying U.S.–India trade fivefold, to $500 billion, over ten years. But beyond just that number, the U.S. should also aim to stay ahead of China in volume of bilateral trade with India. This will likely spur more day-to-day attention to the relationship than a theoretical longer-term target would.

While consistently advocating for U.S. businesses, Washington should not allow individual companies to hijack the agenda. For instance, while India will undoubtedly benefit from opening up its retail market to Walmart and others, this is not necessarily the most pressing economic issue facing the country.

India needs to liberalize its labor and land markets, rationalize expensive food, fuel, and fertilizer subsidies, and privatize loss-making state-owned companies. Over time, as India's economy becomes bigger and more outward-looking, many of these decisions will likely benefit U.S. companies. But they're important mostly because they will unleash India's own economy, raise the living standards of its people, and give it the wherewithal to fulfil the larger role it seeks on the world stage. Though the U.S. cannot make policy for India, it can certainly provide assistance to would-be Indian reformers who look to it for ideas and expertise.

During the Cold War, the U.S. understood that it had a stake in the economic success of countries as different as South Korea and Indonesia. Today, the future of Asia hinges, to a significant degree, on the evolution of India. If it pays off, America's bet on India could be one of the most important investments it makes in the years ahead.