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PUBLIC POLICY | THE UNIVERSITY OF CHICAGO

ECONOMIC REFORM IN INDIA
TASK FORCE REPORT

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TABLE OF CONTENTS

I. INTRODUCTION	3
II. POLITICAL AND HISTORICAL OVERVIEW	4
III. THE POLITICAL ECONOMY OF ECONOMIC REFORM	7
IV. MAJOR ECONOMIC REFORMS AND RECOMMENDATIONS FOR FUTURE REFORMS IN INDIA.....	12
V. SOCIAL IMPLICATIONS	17
VI. INDIA'S VIEW OF ASIA AND THE WORLD.....	23
VII. DOMESTIC IMPLICATIONS OF A CHANGING INDIA.....	25
VIII. CONCLUSIONS.....	30

I. INTRODUCTION

Moving Beyond the Spinning Wheel

In the center of India's flag sits a spinning wheel, a symbol used by Gandhi to protest English textile imports under colonial rule and to demonstrate the nobility of a society of small-scale agriculture and industry. For much of its independence, India's economy was governed by the principle of the spinning wheel – with disastrous economic and social effects. Just as the United States, in industrializing, had to overcome the belief in the nobility of agriculture that shaped its founding fathers, India is still struggling to move beyond Gandhi-era economics and raise its standard of living.

India's recent progress toward economic growth stems from reforms undertaken after the 1991 fiscal crisis, which lifted India from decades of slow growth under socialist rule and offered an opportunity to improve living conditions in the immense, poor country. And the recent growth has been impressive – among the highest growth rates in the world. A great portion of the world's poor live in India, and will depend on its future growth to overcome poverty. But the recent progress is not enough. Certainly, great steps have been taken toward reform on trade, industrial policy, and the financial system; substantial progress has been made in reducing poverty; and India has a growing and thriving middle class. However, much remains to be done: the government intrudes where it need not, in everything from coal mining to discos, and fails to manage the basic services that it should, like decent roads, a stable power distribution infrastructure, and quality primary education.

For the United States, developing its relationship with India is quickly gaining in importance. India is emerging as an important trading partner and as a political counterbalance to Chinese power in Asia – but its power depends on its ability to continue growing. Because its strength benefits the United States both politically and economically, continuing reforms have huge strategic importance for the United States.

This report documents current conditions and catalogues still-needed reforms across India. The central question is not *what* needs to be done, but *how*. A 2001 McKinsey study on required economic reforms still reads as current in 2006. There are pockets of innovation throughout the economy, such as the government's use of the Internet to fight corruption, but much of the population continues to live in shockingly bad conditions. Moving India forward is one of the great opportunities of the early 21st century. We hope that India and its leaders take full advantage.

II. POLITICAL AND HISTORICAL OVERVIEW

Few national symbols are as important as a country's flag. The spinning wheel adorning India's colors is a powerful testament to the historically vital linkages between the country's economy and its political identity. Used by Gandhi as a symbolic protest against British textile imports, the spinning wheel signifies economic and political independence, dearly held values that have driven India's approach to economic policy since Independence. Undoubtedly, the legacy of British colonial rule, socialism, populism, and the interplay between reform and politics have influenced India's historical economic policy and continue to inform paths of future change.

COLONIAL LEGACY

British colonialism left a residual distaste and distrust of foreigners and their economic ambitions. England slowly encroached upon India through the East India Company and eventually exerted full control over the subcontinent. While it did provide India valuable institutions like a court system, railroads, and the English language, the British Raj also exploited the country economically throughout its tenure. Thus, India's independence in 1947 and the appointment of India's National Congress Party ["Congress"] heralded a new era of economic policy dedicated to self-sufficiency. Congress devised the democratic structure of government and flourished politically under Jawaharlal Nehru, Mahatma Gandhi's protégé, who served as India's first prime minister.

Often described by its proponents as a "third way" or "mixed economy," Nehru established a blend of democratic politics and central planning. The nation's pride in its evolving economic reforms is encapsulated by the following statement attributed to Nehru: "a second-rate Indian good is superior to a first-rate foreign product." Nehru established state ownership and import-substitution industrialization in hopes of developing the nation's internal capacity. However, India's socialistic planning failed to develop a strong economy and efficient institutions. Waste and corruption flourished. The state bureaucracy became known as the "License Raj" because its comprehensive scheme of licenses, required for all business activities, created fertile ground for widespread bribes and political kickbacks. For example, one fertilizer factory continued in operation for years without ever producing any fertilizer. While economic growth in many Asian nations surged, the Indian growth rate approximated a sluggish 3% per year until 1990 and was deridingly termed the "Hindu rate of growth."

POLITICS

The most important recent political change in India is the shift away from a single party state. The rise of the Hindu nationalist party (the BJP) and the development of an array of secondary parties have drastically changed the Indian political landscape. Congress dominated politics until 1996, when it was finally unseated by the BJP. While Congress remains an important force, it no longer commands sole power and is often required to

enter into the type of coalition-building pioneered by the BJP. Politics in India are much more fluid than in the United States, with alliances and leaders' political affiliations often shifting in response to popular sentiment.

While the constant shifts in coalitions and interests may be perceived as unstable, the diversity in Indian politics actually serves as glue that holds the political system together. Cross-cutting interdependencies between the multitude of interests force compromise, stability and centrism within Congress and the BJP. Caste conflicts override religious and ethnic divisions, while regional solidarity undercuts intra-regional divides. Although the diversity in Indian politics may inspire stability, it also creates barriers to reform.

POLITICAL BARRIERS TO REFORM

Populism

India's enduring populism derives from both powerful interest groups and the political strength of the lower classes, who vote in greater numbers than the middle or elite classes. Parties often seek to secure short-term political gains through populist policies like subsidies and tax breaks. In an appeal to poor rural voters in 2005, Congress passed a bill that promised 100 days of work for all agricultural laborers, despite the fact that such political pandering drains money from other vital public programs and fails to stimulate the economy. Anti-incumbency trends and the constant presence of elections further exacerbate political fragmentation and populist influence.

The Communist Party

Economic reform proposed by today's ruling coalition is often stifled by the Communist party, on which Congress relies to maintain control. In a very real demonstration of the crippling effects of populist policy in India, the Communists have thwarted many reforms in the run-up to the 2006 spring elections. While the initial reforms of the early 1990s shifted the paradigm of economic policy toward liberalization in all areas, most of the early reforms did not invoke political opposition, leaving many politically difficult reforms ahead. The difficulties also extend far deeper than the presence of the Communist party, which has proved an easy scapegoat. The BJP, without the constraint of the Communists, also failed to drive these politically complicated changes.

Center-State Division of Politics

The center-state division of Indian politics also has important policy implications. Marshall Bouton, President of the Chicago Council on Foreign Relations, said that India resembles the European Union more than a unified nation. Homogenization of politics has not occurred except at elite levels. The 1971 delinking of state assembly polls from national Parliament polls has resulted in a nearly constant flow of elections. While most infrastructure, education and agriculture are managed by state governments, taxing power and revenue-raising ability generally lie with the central government. This misalignment creates difficulties in implementing effective reform policies.

Corruption

Corruption abounds among government officials and everyday workers in India, and impedes economic growth. "It's possible to have more efficient forms of corruption," said Simon Long, South Asian correspondent for *The Economist*. "India has an inefficient form of corruption that doesn't work." While China and India have similar levels of corruption, China is able to accomplish more, because the corruption is less distributed.

Fortunately, attempts to reduce corruption are being implemented at multiple levels of government. Under the recently enacted Right to Information Act, for example, government officials must make information available to the public or face fines. In the municipality of Delhi, a citizen-government participation program called *Bhagidari* – "partnership" in Hindi – encourages direct interaction between citizen groups and politicians in order to reduce corruption. The devolution of power enabled by the 73rd and 74th Amendments, which allow the center to bypass states and send money directly to local governments, has potential to be an effective strategy for reducing corruption by increasing accountability and compliance.

III. THE POLITICAL ECONOMY OF ECONOMIC REFORM

The 1991 Balance of Payments [BOP] crisis forced India to procure a \$1.8 billion IMF loan and acted as a “tipping point” in India’s economic history¹. The IMF bailout wounded the pride of a country that had strove above all for self-sufficiency through its post-independence socialist policies. The bailout announced to Indian policymakers and the world the country’s policy failures.

The BOP crisis immediately confronted P.V. Narasimha Rao’s newly elected Congress government, which had been swept into power in mid-1991 in the aftermath of Rajiv Gandhi’s assassination. Rao had already appointed a non-political figure, economist Manmohan Singh, as finance minister in a gesture that symbolized Rao’s desire to charge forward with economic reform.² In response to the crisis, the government immediately introduced stabilization measures to reduce the fiscal deficit.³ The fiscal tightening and devaluation of the rupee by approximately 25% adequately reduced the current account deficit. Yet, the crisis itself did not spur the significant changes India needed. In the words of Marshall Bouton, a former U.S. diplomat to India and current president of the Chicago Council on Foreign Relations, “The reforms of 1991 were not that big a deal. ... There was no regime change.”

FURTHER STABILIZATION REFORMS

The stabilization efforts of 1991 successfully warded off financial collapse and demonstrated that Rao’s government could be trusted to develop and implement sound economic policy. It was clear the status quo was unsustainable and that India needed to better integrate with the global economic system. Breaking with tradition, the new Congress government went beyond traditional short-term stabilization efforts and began addressing the underlying causes of India’s economic woes.

Led by Singh, the government initiated a reversal of the historic policies of regulation and government intervention. Rakesh Mohan, who served as Secretary of the Department of Economic Affairs, believes that the experience of enacting smaller reforms in the 1980s gave Rao’s team the confidence to react swiftly with broader reforms like market-determined exchange rates, liberalization of interest rates, reductions in tariffs, and a dismantling of the License Raj.

Appealing to the Indian aspiration of self-sufficiency, controversial reforms in areas like taxation, financial services and public sector management were developed and approved by Indian committees rather than by external bodies like the World Bank or IMF.⁴ The government also selected these early reforms carefully, fearing that with India’s constant cycle of elections, any setback at the polls would damage the reforms’ momentum. Thus, the government attacked glaring problems but also avoided politically costly changes.

FISCAL AND ADMINISTRATIVE REFORMS

Initial fiscal reform focused on politically feasible revenue-related issues like rationalizing the tax structure and increasing compliance. Rao and Singh had to abandon their initial attempts to curb the deficit through spending cuts, and by 1996, the annual deficit had climbed back to 1991 levels – 10.5% of GDP.⁵ Sensitive to public opinion, reformers could not break the vicious cycle of overexpenditure and poorly targeted spending.

The center government drove an initiative to move the country toward a Value-Added Tax system, and by 2005, most state governments had adopted it. According to Delhi's Secretary of Finance Sanjeev Khairnar, the VAT contributed 70% of Delhi's total revenue collection, but many others questioned the extent of its implementation nationally. States choose their tax levels, and the long lines of trucks at state borders illustrate the inefficient competition that results.

The distribution of responsibilities between state and central governments in tax collection and public good provision has created perverse incentives, with states and municipalities poorly utilizing resources and failing to deliver. Local governments also suffer from even greater fiscal problems. Tax evasion is rampant, with some business and public leaders estimating that a mere 20% of taxable revenue is actually collected. The poor performance of the government only exacerbates the tax-evasion problem. Ultimately, greater cooperation among the different levels of government is needed to coordinate decision making, expenditure targeting, and tax collection procedures.

FINANCIAL SECTOR REFORMS

In order to liberalize the financial sector, Rao established committees to research and make recommendations regarding financial system modernization, deregulation, and lending improvements. The committee-based approach reflected Rao's strategy of building consensus through Indian-led and designed plans.

Before the 1990's, regulations limited the ability of the Indian financial sector to efficiently allocate resources. Regulations required heavy investment in government debt, while lending was restricted to specific sectors. Bank nationalization left management of most financial institutions to political forces.

Efforts to privatize and introduce competition were approached cautiously, due to the political sensitivity of these reforms and resulted in more limited change than did deregulation.⁶ Changes did not impact the banking workforce or management structure; banks remain overstaffed and poorly managed. Trade unions persist as a formidable enemy of future reforms aimed at reducing operating expenses.⁷ The large and mobilized workforce, associated with the Communist parties, has gone on strike in the past, holding the entire banking system hostage.

INTERNATIONAL TRADE AND INVESTMENT REFORMS

India's trade policy prior to the 1991 reforms was characterized by high tariffs and import restrictions. Foreign-manufactured consumer goods were entirely banned, and capital goods, raw materials, and intermediate goods for which domestic substitutes existed were importable only through a bureaucratic licensing process. Illustrative of the severity of the situation, Infosys executives described how the founders had to visit Delhi nine times to obtain a license to import just one personal computer.

Although foreign ownership in some Indian companies was permitted, investors faced complications that included a subjective licensing process, high regulation upon approval, and equity-holding caps. In fact, until recently Indians had only one television program and had to settle for locally-produced Thumbs Up instead of Coca-Cola.

India has come a long way toward opening its borders to trade – exports and imports grew at 19% and 30% in 2004 and 2005 respectively – and both Congress and the BJP are committed to increasing free trade. India has and should continue to take advantage of the WTO as a cover against domestic backlash to further tariff reductions. Concessions like temporary subsidies may be necessary to placate short-term losers in non-competitive industries. Investment has increased throughout the past decade and a number of important industries like aviation and construction have raised or eliminated caps on foreign investment.

Despite the benefits of outside technical expertise, many fear that increased foreign investment will lead to lost jobs and threaten domestic businesses, especially businesses like the mom-and-pop shops of the retail sector. The Communist Party and many labor unions are vocal supporters of such small-scale industries and fight against liberalizing foreign investment. Tariffs also remain among the highest of the developing world.⁸ This further confirms that, with a 2003 trade deficit of around \$17 billion, India's exports are not yet competitive on global markets.

INDUSTRIAL SECTOR REFORMS

India's industrial policy was one of the areas most changed by the economic liberalization of the 1990s. The early reforms crystallized a trend that had been building since the national government moved toward a pro-business approach to industrial policy during the 1980s. During the following decade, India transitioned from a centrally planned and operated economy to a market-driven economy, reflecting a global trend toward less regulated economies. Most government-operated industries in India are now privatized, though some political contention still exists over the removal of reservation schemes.

INFRASTRUCTURE REFORMS

A short drive through any Indian city reveals some of the serious deficiencies of India's infrastructure: roads full of potholes, relentless traffic, suffocating pollution. Even the elite

Taj Hotel in Delhi is not immune to power outages (although its backup generators react quickly). According to the 1999 Global Competitiveness Report, India ranked 55 out of 59 countries in terms of the “adequacy of overall infrastructure.”⁹

Power failures are the rule rather than the exception. Additionally, many estimate that more than half of all electricity is obtained illegally. This leaves little incentive for users to conserve energy, while the public sector is ill-equipped to improve the system as needed. India’s Planning Commission estimates that in order to meet the growing demands of the economy, the country needs to triple its power generation capabilities over the next two decades. Coal, renewable energy, nuclear power, and domestically-produced petroleum and natural gas will not meet India’s energy needs and so the government is looking for foreign sources of petroleum and natural gas.

Although an efficient infrastructure is in the national interest, state governments control many infrastructure projects. Large private sector organizations are taking care of their own infrastructure needs in response to state governments’ neglect. Infosys, for example, maintains a fleet of nearly 600 buses to transport its 12,000 employees to work. Prime Minister Singh has declared that India must raise levels of investment in infrastructure to enable the nation to reach its goal of 8% growth.¹⁰ Unfortunately, due to India’s large deficit, the nation often skimps on infrastructure spending.¹¹ Additionally, improvements in center-state cooperation are greatly needed.

LABOR REFORMS

While less than 10% of the 500 million-person labor force is “organized” or has regular contractual employment,¹² labor regulations have made unions a powerful force in Indian politics. The tide is beginning to change, however. There are fewer labor strikes today, labor agreements now generally include clauses on productivity, and court judgments are no longer reflexively in favor of labor.¹³

While Rao recognizes the need for labor reform, he has hesitated to implement reforms like laying-off public sector workers or closing down or privatizing inefficient factories. Additionally, it remains difficult to fire workers, and employers are hesitant to hire new ones. A 1947 act mandates state governments to require manufacturing firms with over 100 workers to gain governmental approval before firing workers. According to Nandan Nilekani, CEO of Infosys, the lack of a flexible labor policy is an important impediment to India’s growth.

AGRICULTURAL REFORMS

Prime Minister Singh maintains that India must improve conditions for farmers and invest more in education and health care to reach its goal of 8% growth.¹⁴ He aims to modernize agriculture and increase manufacturing by expanding agribusiness and food processing.¹⁵ Yet any change to the agricultural sector faces intense political opposition. Despite the fact that it contributes only 20% of India’s GDP, the agricultural sector has always been

politically influential. Interest group politics often hinder government attempts to cut costs in its agricultural spending. For example, Prime Minister Singh recently attempted to decrease government fertilizer subsidies but was stopped by a farmers' lobbying group from wealthy agricultural states.

Agricultural subsidies for poor farmers have been part of the Indian landscape since Independence. The support system for farmers included large fertilizer subsidies, free electrical power, protection for land owners, and minimum price guarantees for grain production. While these programs allowed India to avoid famine in the 1970's, they have created perverse incentives and opportunities for corruption. Fertilizer subsidies have contributed to over-fertilization and contamination of ground water. Additionally, subsidies often do not reach target populations. In Delhi, for example, many affluent neighborhoods have been classified as rural areas and receive free electricity. Finally, subsidized prices have led to the overgrowth of certain crops. The Indian government makes inefficient purchases of food staple crops at above-market prices with the intention of redistributing them to the poor. But such goods rarely reach their intended destination, due to corruption and inefficiencies.¹⁶

PRIVATIZATION REFORMS

The Government of India runs coal mines as well as discotheques. Public enterprises account for nearly half of India's capital stock¹⁷ and enjoy commanding market shares in industries like mining, smelting, banking, and railways. Most, however, exhibit poor productivity of labor and capital. Many public enterprises were created and kept alive for political reasons. For example, a fertilizer factory in Haldia, West Bengal, kept thousands of workers on its payroll for years without ever commencing production

CONCLUSION

Overall, the reforms of the early 1990s were no major feat of political acumen. Congress faced little organized opposition to early change and could institute many reforms through executive action. Future reforms that require legislation will entail more complex political maneuvering. The government will need to counteract the forces of populism and increased political fragmentation. The party lacks a strong internal pro-reform caucus, has difficulty building coalitions with some regional and caste-based parties, and maintains a record of inconsistent economic policy.¹⁸ Although difficult, change *is* slowly taking place. Finding the lines of least resistance for each particular issue will be key for shepherding reforms through India's unique democracy.

IV. MAJOR ECONOMIC REFORMS AND RECOMMENDATIONS FOR FUTURE REFORMS IN INDIA

While the U.S. media has focused on India's increasing competitiveness in software development and information technology, software and IT constitute only a small part of the Indian economy: more than 50% of India's output comes from its manufacturing and agricultural sectors, and 70% of its labor force is employed in agricultural. India needs policies to improve these sectors' long-term competitiveness in order to sustain and enhance its current growth rate. The reform process of the last 15 years is far from complete.

FISCAL AND ADMINISTRATIVE REFORM

India's fiscal policy is a key part of its overall economic history and central to its growth prospects. It was a major contributor to the 1991 BOP crisis, and in the future, persistent budget deficits may hinder the country's economic growth. The shortfalls of India's public services and infrastructure are quite obvious, and a miserable fiscal policy is a major reason for this gross underinvestment. While inadequate public revenues and low rates of public savings have contributed to India's fiscal shortcomings, the heart of the problem lies in India's public expenditures and management systems. Major administrative reform is required.

What's Been Done

India's fiscal reforms focused on generating revenue through rationalizing the tax structure and increasing compliance. Specifically, the reforms:

- Lowered taxes (individual, corporate, excise and custom)
- Broadened the tax base;
- Removed exemptions and concessions to reduce distortions;
- Simplified laws and procedures to close loopholes and increase compliance, including using technology to better track tax payments.

Unfortunately, total tax revenues fell from 9.7% of GDP in 1990-91 to 8.8% of GDP in 2000-01.¹⁹ Additionally, India's current fiscal deficit of \$37 billion places it among the highest in the developing world, and its public debt hovers around 60% of GDP.²⁰

The Way Forward

"If India's government is going to make a difference, it needs to raise more taxes," *The Economist* wrote recently, which, considering the source, indicates the severity of the problem.²¹ To improve its tax system, India should:

- Increase taxes on services and implement a tax on e-commerce;
- Modernize tax administration through better utilizing technology;
- Restructure tax collection and allocation system to increase revenues at local and state levels;

- Complete the replacement of complex sales taxes with a more coordinated, coherent VAT system;
- Use technology to better enforce property and agricultural income taxes;
- Remove distortionary tax exemptions;
- Reduce the mean and variance of import tariffs;
- Repeal the corporate tax.

On the expenditure side, the various levels of government should:

- Reduce subsidies (which are generally poorly targeted);
- Downsize overstuffed public institutions, particularly at state and local levels;
- Separate policy and implementation functions through administrative reforms;
- Reduce bureaucratic controls and set performance targets;
- Institute mechanisms like greater public transparency to increase accountability.²²

FINANCIAL SECTOR REFORMS

Because the BOP crisis prompted reforms of the financial system, this sector has experienced some of the most extensive improvements.²³ India must continue to deepen its financial sector in order to guarantee adequate access to capital for its most dynamic industries. This can be achieved through the involvement of venture capital funds, the expansion of corporate debt markets, and the modernization of public bank management.

What's Been Done

India has implemented reforms that have led to relatively well-functioning capital markets. These reforms:

- Liberalized interest rates;
- Abolished cumbersome approval requirements for financial transactions;
- Liberalized capital markets through the abolition of the Controller of Capital Issues, which controlled all funding activities of large manufacturing corporations;
- Allowed companies to more easily sell stock.

The Way Forward

In order to continue supporting the most dynamic sectors of the economy, India should:

- Design strategies to increase venture capital;
- Allow investment in securities as an alternative to domestic saving in order to reduce reliance on foreign inflows in capital markets;²⁴
- Allow pension funds to invest in stocks;
- Improve and deepen debt markets for larger corporations;
- Increase competition from commercial and foreign banks in the financial sector.

INTERNATIONAL TRADE AND INVESTMENT REFORMS

Having moved from barring foreign ownership in a wide swath of industries to encouraging foreign investment, India has made significant progress in opening its economy. Yet, while

its foreign investment inflows increased from 0.5% of GDP in 1991 to 4.1% in 2000, these figures are dwarfed by other emerging Asian markets, particularly China.²⁵

What's Been Done

Recent trade and investment policy reforms:

- Eliminated import licenses and reduced import duties from rates that had been the world's highest;²⁶
- Reduced tariffs;
- Liberalized trade in service and technology industries;
- Improved recognition of international intellectual property rights;
- Allowed 100% ownership in firms in a large majority of industries (excluding banks, insurance, telecommunications, and airlines);

The Way Forward

To improve its trade and investment environment, India should:

- Further reduce import duties and restrictions;
- Reduce costly procedures for exporting finished or intermediate goods;
- Attract foreign investment to meet demand for infrastructure projects;
- Reduce foreign investment barriers within the retail sector;
- Invest in infrastructure and education, as a recent survey of global CEOs cited infrastructure and poor skill level as the two leading deterrents;²⁷
- Pursue free trade agreements in the spirit of creating a greater global balance and to advance India's economic interests.

INDUSTRIAL SECTOR REFORMS

While the chairman of Ittiam, a Bangalore commercial electronics design firm, attributes the success of the Indian IT industry in part to the absence of government regulations, government policy continues to limit manufacturing growth and hinder the ability of business to take advantage of the country's pool of cheap labor.

What's Been Done

Industrial sector reforms:

- Opened up the economy broadly to competition; and
- Reduced reservations for some small-scale industries.

The Way Forward

To build on its success in industrial policy reform, India should:

- Further reduce reservations for small businesses; and
- Formalize special economic zones (SEZs), where normal investment and trade restrictions do not apply, to help leverage further reform.

Though small in comparison to China's vaunted SEZs, such efforts may hail a more drastic sea change in industrial policy as new ideas for further reforms become more prevalent in Delhi's circles of power. Milind Deora, a young and rising member of India's parliament, sees such a shift occurring today, suggesting that "the old guard is leaving."

INFRASTRUCTURE REFORMS

Infrastructure remains perhaps the greatest drag on India's current growth prospects. Major public work projects, however, present implementation challenges, particularly due to corruption.

What's Been Done

Previous infrastructure reforms:

- Invested, with limited success, in improving airports and road networks;
- Privatized successfully a small number of ports and roads;
- Improved the reach of the telecom sector.

The Way Forward

India's growth will be severely jeopardized without substantial improvements in infrastructure. India needs to:

- Implement major public works projects, taking advantage of public-private partnerships where possible;
- Privatize the energy sector and base user-charges on economic cost (some states have already taken lead in this effort);
- Continue to increase tele-density among its population, as India remains way behind countries like China and Thailand;²⁸
- Increase transparency in implementing infrastructure projects;
- Invest in a variety of renewable sources like ethanol and wind energy.

LABOR REFORM

Although India's restrictive labor laws are not a problem during times of expansion and do not affect high-skilled workers in the software and R&D sectors, they discourage further private investments, particularly in the manufacturing sector.

What's Been Done

Labor markets remain one of the most regulated sectors of the Indian economy as labor reform was not addressed in the early 1990s.

The Way Forward

A more flexible labor policy will support business development and enhance India's growth. In particular, policies should be designed to:

- Remove restrictions on laying-off workers;
- Moderate benefits obtained by unions;
- Deregulate wage practices.

Labor reforms should be coupled with the creation of a stronger social safety net to support affected employees.

AGRICULTURAL REFORM

As the majority of the labor force still works in agriculture, reform of this sector is essential for widespread growth and to reduce income inequalities. Reform measures should enhance both production and marketability of the country's agricultural production.²⁹ Additionally, changes will allow some Indian agriculturalists to find income alternatives while they gain greater skills necessary for work in the manufacturing sector.

What's Been Done

Agriculture has been largely ignored in the reforms of the last 15 years due to entrenched interest groups.

The Way Forward

Substantial deregulation of the agricultural sector is necessary in order to increase India's competitiveness in world markets. To achieve this, the government should:

- Eliminate subsidies that have largely benefited interest groups rather than poor farmers, in order to align incentives and liberate resources from state budgets;
- Reallocate these freed-up resources toward urgent public interventions, such as building roads, irrigation channels, and refrigeration facilities.
- Eliminate artificial price supports for food goods to reduce corruption and distortionary farming incentives.

PRIVATIZATION REFORMS

What's Been Done & The Way Forward

After the onset of economic liberalization in 1991, the government made valiant efforts toward privatizing public enterprises. However, political difficulties have forced it to backtrack time and again. The frustration of the present government on this issue is made clear in a statement by Prime Minister Singh that "we have to make compromises."³⁰ As economic reforms continue, the government will have to find ways to negotiate new compromises that include privatization.

V. SOCIAL IMPLICATIONS

The image of an “India Shining” post-1991 is hardly a representative or fully accurate portrayal of a country where over 100,000 villages have never heard a telephone ring. While the economic reforms of the 1990s did much to liberalize and stimulate growth, the direct beneficiaries were more affluent urban dwellers. About a quarter of India’s one billion-plus population, who constitute a third of the world’s poor, continue to live in poverty.³¹ Over 70% of Indians live in deprived rural areas. This is the challenge of a country heralded as the home of the new Silicon Valley, where oxen and trucks share highways, and where preventable diseases like polio are rampant.

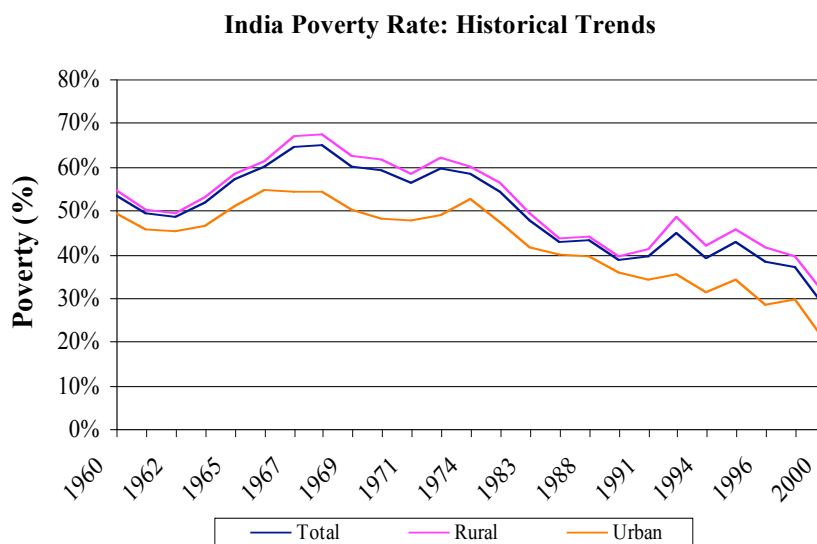
In a country run largely by economists, social reform has lagged behind economic reform. The United Nations Development Programme ranked India lower based on its life expectancy, access to education, and standard of living than many countries with comparable, or lower, GDP per capita. India also has the world’s largest illiterate and HIV-infected populations. The state of Bihar seems to encapsulate all of India’s woes – a poverty rate greater than 40%; utter corruption; a deeply rooted caste system which has historically limited opportunities to those born into the lower castes; and 75% of its villages without primary schools, health care, and electricity.³² In contrast, the state of Kerala is India’s success story of social reform, which boasts over 90% literacy; health and mortality measures comparable to developed countries; and a strong commitment to universal education and equity. Still, over 90% of its residents are unable to find employment within the state.³³ If India is to achieve continued economic growth and define herself as a world power, social and economic reform must occur in tandem.

POVERTY AND INEQUALITY

Although poverty has continued to fall with economic reform, it is evident that growth in and of itself will not eliminate poverty. Over a quarter of the country continues to live in poverty.

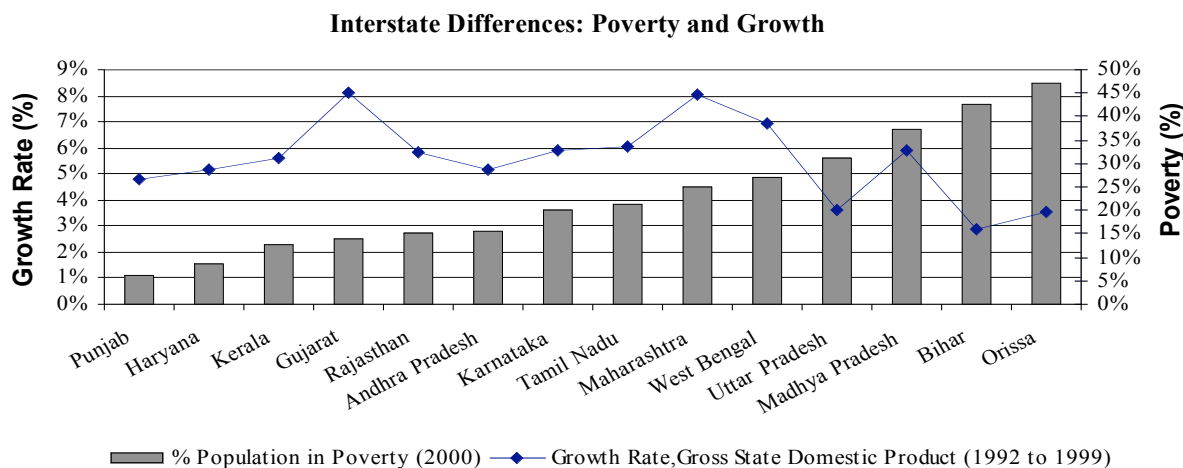
The widening of regional and interstate disparities during the 1990s, despite overall economic liberalization, highlights the importance of strengthening slow-growing states. In China, there are relatively few poor, rural areas, but in India, these are the heartland.

Wealth is generally more concentrated in urban rather than rural areas where the majority



Source: The World Bank.

of Indians live. Economic growth also tends to be higher in wealthier states in the south and west such as Gujarat and Maharashtra than poorer states like Bihar, Orissa, and Uttar Pradesh in the north and east.³⁴ Investment will naturally flock to the more developed regions equipped with infrastructure advantages. Additionally, with mounting pressure from internal migration from depressed states like Bihar, investing in human development and poverty reduction in states left behind may be key to enhancing the national stability that allows liberalization and growth to proceed.



Source: Ahluwalia, Montek. "State-level Performance Under Economic Reforms in India," in Anne O. Krueger (ed.), *Economic Policy Reforms and the Indian Economy*. The University of Chicago Press: Chicago, 2002.

EDUCATION

"You can say almost anything about India, and be right," said an economist at the U.S. Embassy in Delhi. This may never be more true than when discussing India's education system, which produces both world-renowned engineers and one-third of the globe's illiterate population; education is perhaps the country's great unequalizer. Those graduating from India's top-notch Indian Institutes of Technology (IITs) and Indian Institutes of Management (IIMs) are poised to compete with the world's best and brightest. But the top accounts for only a tiny tip of a distorted pyramid. At its massive base, 40% of the population is illiterate, a rate worse than several sub-Saharan African countries. In all parts of the economy, the country's human capital presents a constraint, from looming shortages of high-tech workers to labor productivity in manufacturing that is about half that of China.

Even within India's celebrated higher education system, few of the 2,000 engineering schools and numerous other institutions meet international standards. While popular media sources, from New York Times columnist Thomas Friedman to Business Week,³⁵ depict a vast pool of cheap, well-educated labor eager to snag jobs away from unprepared, complacent Americans, the system is already straining to meet demands for skilled workers. To hire 16,500 employees, Infosys must consider 1.3 million applicants, "which tells you how fast the funnel drops," according to Mr. Purohit, head of strategic planning at Infosys. More generally, the scarcity of qualified workers is juxtaposed with a growing number of graduates looking for work, many whose skills and educational training bears

little resemblance to the market’s needs. In fact, only 17% of India’s students pursue degrees like engineering or medicine.³⁶

After decades of excessive focus on higher education and severe underinvestment in basic education, India is now making widespread progress on several education measures, as illustrated the chart opposite this discussion. In 2003, a constitutional amendment declared education a citizen’s “fundamental right.” Significantly increased resources and broad initiatives like providing mid-day meals and targeting educational programs for lower-caste children have helped India implement its free and compulsory education laws. “The realization that basic education had really been neglected sunk in only in the 90s,” said Dr. Shiv Kumar, a member of the Congress Party’s Advisory Council and economic consultant to UNICEF.

Chart [A]: Progress in Education

	1990	2002
Literacy rates		
Females	36%	45%
Males	62%	68%
Enrollment rates		
Primary	68%	82%
Secondary	44%	50%

Source: The World Bank.

The huge challenge remains of improving the often abysmal quality of India’s government-run primary and secondary schools. India has yet to demonstrate commitment to improving its woeful public management and service delivery, particularly at the local level. Inadequate, ill-equipped government schools overflow with children who have no choice, while those whose parents can scrape to afford it rush to private schools.³⁷ Only a quarter of students who start government schools graduate from the 8th grade, and the term “multi-grade schools” merely serves as a euphemism for one teacher and 250 students. Even when schools are structured differently, students share a similar reality: many teachers collect paychecks but simply do not show up for school, a striking example of the toll that petty corruption takes on the poor.

HEALTH

Although India presents itself as an emerging power, its malnutrition rates – twice those of sub-Saharan Africa – say otherwise. About half of Indian children will forever bear the physical and mental consequences of what the World Bank calls the country’s “silent emergency.” That about 20% of children’s deaths in the world and a quarter of all maternal childbirth mortality occur in India further indicate the depth of India’s neglect of health. Even among similar-income countries, India’s expenditures on health are woefully low, at less than 1% of the country’s GDP and half of China’s per capita spending. And while AIDS is approaching epidemic proportions, it continues to receive relatively scant attention from the government. This utter neglect has also impeded India’s ability to receive foreign assistance to combat the disease. David Mulford, U.S. Ambassador to India, explained that a key reason the U.S. has not designated India a priority country in its global assistance against AIDS is that the Indian government has failed to demonstrate sufficient internal commitment to the crisis.

Still, the picture of India's health is not entirely bleak. Since Independence, the life expectancy of its population has increased astonishingly from about 32 years to almost 65 years,³⁸ and its infant mortality rate has been halved (although it remains higher than in neighboring Bangladesh). Facilities and care for the minority who can afford it have reached world-class levels. While challenges are vast in addressing the health of the poor, innovative health programs that capitalize on the resources of the local communities offer promise. For example, the Tamil Nadu-based George Foundation runs a village health clinic that trains villagers as health aids; provides pregnant women with education and clean supplies for inevitable home deliveries; and uses software to guide diagnoses and track local disease patterns in areas where doctors are scarce. Such programs need to be brought to scale by the government. However, similar social programs will not work without improvements to monitoring systems to address the inadequate delivery of public health services and exploitative private practices. Additionally, vulnerable families struggling to rise out of poverty need the protection of insurance so that health problems do not lead to economic devastation. The success of the government in designing and implementing such measures will largely influence how India's prosperity is experienced by the poor.

RURAL EMPLOYMENT

If economic growth is to continue, employment opportunities must be made available to India's rural poor. Only about a million people or around 0.1% of India's population are benefiting from employment in India's rapidly growing outsourcing, IT, and services industries.³⁹ The majority of people reside in rural areas. Roughly half of the poor are employed in agriculture,⁴⁰ which makes up about a quarter of India's GDP, but its growth waxes and wanes with the monsoons. It also attracts only 7% of public and private investment, limiting its impact on overall economic and employment growth.⁴¹

India must strengthen labor-intensive industries like manufacturing if it is to reduce poverty and increase growth in rural areas. Fewer workers are being employed in the agriculture sector as the use of machinery and labor-reducing cropping techniques have increased. India's surplus of rural workers could be shifted to manufacturing textiles or to the construction sector given India's enormous infrastructure needs. Manufacturing, however, has in fact grown at an annual rate of 7%, but these gains have been due to increased productivity, not job growth. China's manufacturing market, on the other hand, has boomed with job-oriented growth. The labor-intensive textile industry could add an estimated 12 million jobs over the next five years if India would reform its restrictive labor laws and regulations.⁴²

GENDER

One of the starkest indicators of India's gender disparities is the phenomenon of its "missing women". As experts consider it natural for the number of women in a population

to outnumber men (due to “hardier” girl children and longer life expectancies), India’s female-to-male ratio of only 93 to 100 suggests that poorer health and nutritional care of girl children has led to millions of premature deaths. Better education and economic empowerment generally reduce fertility rates and improve the health and nourishment of all children, in turn restoring more natural gender ratios. Once again, Kerala provides an example of what is possible – its female-to-male ratio is comparable to Western nations and its fertility rate at 1.3 is even lower than that of the United States, which hovers just around 2.1.

One counteracting factor in improving gender ratios, however, is that educated Indian women continue to profess a strong preference for sons and are more likely to seek sex-selective abortions. In fact, son-preference is so deeply ingrained throughout the population that Dr. Shelly Batra, M.D., a prominent Delhi gynecologist commented, “When a child is born, we don’t say whether it is a boy or girl because the woman will go into shock.” The country has made sex-selective abortion a crime and has initiated a national campaign against the practice. Yet, despite an increasing percentage of women in the overall Indian population, the 2001 census showed a notable decline in sex ratios in the 0-6 age range – a decline that was most dramatic in wealthier states.

CASTE

While caste is often portrayed as a feature of Indian life of fading importance, and one concentrated in rural areas, the caste system continues to assert itself through social inequalities and voting patterns. Efforts to address caste inequalities by affirmative action have been mixed and are consigned to the shrinking public sector. While Gucharan Das, author of *India Unbound*, argues that the increased competition of economic liberalization has worked to further undermine caste privilege in business circles by creating the need to hire based on merit rather than shared caste, this is irrelevant to the many floundering at the bottom without access even to clean water. Politically, while the divisions and identity politics run deep, recent elections offer a sliver of hope that India’s politics is beginning to move away from a destabilizing emphasis on communities and caste and toward a focus on development and governance.

ENVIRONMENTAL CONCERNS

With increasing industrialization, India has become the world’s sixth largest energy consumer and home to some of the most polluted cities. India’s energy needs have only exacerbated poor air quality. Over half of its energy generation comes from coal and its production of carbon emissions is expected to grow 3% annually until 2025, surpassing the U.S. rate of 1.5%.⁴³ With an eye on growth, India did not sign the 2002 Kyoto Protocol, which set emissions caps. But India has recognized its need to address environmental issues, as signaled by its decision to join the six-country Asia-Pacific Partnership on Clean Development and Climate in July 2005 and its renewable energy initiatives.

Overuse of energy and water are also environmental threats in rural areas. For example, poorly priced and heavily subsidized irrigation pumping has resulted in substantial waste of energy and water. The overuse of water sources has depleted groundwater levels in some areas by 1 to 3 meters per year, requiring the use of larger, power-eating and pollutant-emitting pumps.⁴⁴ Land degradation, deforestation, soil erosion, and water pollution also continue to complicate conservation and development in rural areas. Environmental concerns, however, are often secondary to growth. Removing subsidies and allowing market forces to dictate prices is politically difficult. And, even if programs are adopted, their success is often frustrated by the division of power between levels of government.

CONCLUSION

In a November 2005 presentation in Chicago, Rakesh Mohan, Deputy Governor of the Reserve Bank of India, stressed that India's next wave of reform must focus on improving the provision of education, health, and other social services in order to achieve higher growth rates.⁴⁵ This will require higher levels of public investments through tax-increasing or subsidy-reducing legislation. Yet, India's governments continue to be saddled with large deficits, with funds spent largely on repaying debt. Even if more funding is allocated toward social programs, India must tackle corruption, power conflicts between central, state, and local governments, and the poor management and distribution of resources. Efforts must be made to improve delegation of authority to local levels and to increase accountability and transparency. Only then will continued growth be sustainable and the social livelihood of millions of Indians be improved.

VI. INDIA'S VIEW OF ASIA AND THE WORLD

Three years ago, a discussion of India's geopolitical worldview would start, and most likely end, with Indian-Pakistani relations. Today, however, sustained economic growth has allowed India the confidence to "de-hyphenate" itself from Pakistan, and pursue broader, more ambitious goals. As New Delhi looks past Pakistan toward carving out a larger sphere of influence, she will inevitably come into conflict with China, whose leaders continue to reiterate their conviction that China will not be satisfied with being a second-rate or regional power, but will aspire to world economic and military dominance.⁴⁶ Moreover, both countries are fully aware that the basic premise of American strategy in the region is "to prevent the emergence of any great power that can challenge American dominance in Asia."⁴⁷

China's extraordinary economic and military growth will create serious implications for India's military security and her aspirations for regional leadership. Although China lagged behind India as recently as 1978, China's current per capita income is nearly double that of India's. As *The Economist* states: "If this is a race, India has already been lapped."⁴⁸ China's growth, in concert with Beijing's talk of a "Chinese Century," makes China's neighbors, and the rest of the world, nervous. As the only Asian country capable of effectively balancing China, India is becoming a focal point.



THE BALANCING GAME: A POTENTIAL INDIAN ASSET?

China's rise provides a window of opportunity for India to exert greater leadership on the world stage, increase economic cooperation with the world's two largest economies, and further its own politically difficult reforms. Recently intensified U.S.-Indo joint military exercises hint that India is already emerging as an answer to Washington's "China question."

America's National Intelligence Council has "likened [China's] emergence in the early 21st century to the rise of Germany in the 19th."⁴⁹ In the coming decades, the U.S. will try to do

exactly what China is trying to prevent: build a network of Asian States, led by India, to balance China, and, thus, limit its influence to within Asia. If a successful Indo-U.S. relationship can be formed, then India will reap the benefits of U.S. balancing efforts, which may include preferred trading, weapons sales, technology transfers, and nuclear capabilities. Aside from material benefits, millions of Indians receive advanced degrees in America's "open door" universities, and much of India's recent IT growth is due to the willingness of U.S. markets to receive their products and services. Anyone can witness the growing human connection between the U.S. and India by simply stepping on a college campus, taking a flight to the U.S. from nearly anywhere, or calling a 1-800 tech support line.

Although Sino-Indo trade is increasing quickly, Chinese political organization and behavior make her a potentially infeasible ally to India. More specifically, her occupation of Indian claimed territory in Kashmir; continued support for Pakistan; invasion of Tibet; and support of Burma make alliance with China politically and strategically unfavorable. Latent Chinese aggression toward India fits into a more general strategy to prevent countries – most notably the U.S., Japan, and India - from allying against her. Beijing's "peace and friendship" rhetoric embodies this concern.⁵⁰ China has made active efforts to distract India and co-opt her neighbors, in hopes that an anti-Chinese block of Asian nations will not form.

India's continued fixation on Kashmir is the biggest weakness of the potential balancing coalition, and China has happily used that weakness to drive a stake between India and the U.S., who considers Pakistan a valuable ally in the War on Terror. China supplies Pakistan with nuclear technology and conventional weapons to keep India focused on her adversary and, thus, distracted from wider goals.

CONCLUSION

India's future may very well depend on her ability to cope with her troubled past. America is a potentially strong ally who is courting Indian favor. For the relationship to fully form, however, India must learn to live with America's continued support for Pakistan and to manage Chinese meddling. India is a self-confident country. It remains to be seen if she can finally break her fixation with her step-sister Pakistan.

VII. DOMESTIC IMPLICATIONS OF A CHANGING INDIA

India will be the most important relationship the U.S. will have going forward.

David C. Mulford, U.S. Ambassador to India

The top three priorities for U.S.-Indian relations should be to: 1) continue de-hyphenating India and Pakistan; 2) expand India's standing on the world stage with a strengthened U.S.-Indo relationship; and 3) encourage domestic reforms and keep markets open.

The end of the Cold War combined with India's 1991 economic reforms transformed the relationship between the United States and India. No longer was India a socialist power aligned with the Soviet Union, but rather an emerging Asian capitalist democracy. Two further trends have encouraged a tightening of the U.S.-Indo relationship: the rise of China as an economic power – causing the United States to seek a balancing power in Asia – and the growing interdependence between the two economies through greater trade and travel. Leaders in both countries would like to see a closer relationship, but they face entrenched opposition in their respective domestic legislatures: opposition to outsourcing and nuclear proliferation in the United States, and generalized distrust of the United States by Indian politicians – especially in light of its relationship with Pakistan.

The United States should pursue policies that strengthen the nascent U.S.-India relationship that has emerged since the end of the Cold War. To further its potentially valuable partnership with India, American policymakers should pursue the following policy objectives: 1) 'De-hyphenate' its relationships with India and Pakistan; 2) Strengthen India's standing on the world stage – and its relationship with the United States – in search of a balance of power in Asia; and 3) Encourage India's growth by maintaining an open trade relationship despite the temptations of anti-trade populism. All of these objectives are good for the U.S. and for India. The challenges lie in navigating complicated domestic and international political scenes to achieve them.

SEEK INDEPENDENT RELATIONSHIPS WITH INDIA AND PAKISTAN

“Nothing is fiercer than a war over ancestral land between two half-brothers.” This unattributed aphorism seems to fit the conflict in Kashmir quite accurately. Indeed, the global nonproliferation debate has often centered on the conflict in this region. Hostilities have plagued the India-Pakistan relationship since Partition, fueling a border dispute that has erupted in several wars and resulted in deaths of countless Kashmiris caught in the middle of the clash. Though India has long been a vocal proponent of global nonproliferation, it has also been realistic about the threat posed by the nuclear capabilities of its neighbor. As a result, India's decision to “go nuclear” and to defer becoming a signatory of the Nuclear Proliferation Treaty (NPT), the basis for international efforts to curb the spread of nuclear weapons since 1968, has been a sticking point in relations with the U.S.. However, the end of the Cold War has presented an opportunity for the U.S. to reassess its global strategic alliances. As a result, the U.S. has begun to explicitly “de-

hyphenate” India and Pakistan in its foreign policy, now seeking strategic relationships with both, rather than at the expense of one over the other.

Military interests have always figured prominently in the U.S.’s relationship with Pakistan. In the wake of September 11, 2001, the U.S. has built on its Cold War alliance with Pakistan against the Soviet Union to ensure the additional military cooperation necessary for counter-terrorism operations in the region. In addition to promoting lucrative trade and sourcing relationships with India, the U.S. has also recently begun joint military training operations in pursuit of shared security goals, such as a recent air force exercises in Calcutta, known as COPE India.⁵¹ Though greater stability in India-Pakistan relations appears to remain in its beginning stages, the absence of discussion on the issue in a recent address by the U.S. Ambassador David C. Mulford to the Chicago Council on Foreign Relations on emerging policy priorities suggests that the U.S. is in fact serious about its efforts to de-link the two countries.⁵² Still, the Ambassador’s silence on this issue omits the fact that the U.S. had been instrumental in influencing both sides to work toward cooperation, based on its promises of supports for both countries.⁵³

Despite U.S. intentions to pursue distinct strategies with each country going forward, there is great risk that Pakistan will view the U.S.-India bilateral agreement as a threat to its own interests, which could undermine the relative stability in Kashmir. Additionally, according to a senior official at the U.S. Embassy on the administration’s scheduled January 2006 visit to the region, “Indians have gotten used to the idea that Bush will visit Pakistan. The question is when and who he will meet.” Understandably, India and Pakistan are both apprehensive about the implications of evolving U.S. relations with their respective neighbor. The U.S. must therefore be explicit in treating each country autonomously: though it is within the United States’ best interests to keep the peace in Kashmir, the shared territory must no longer continue to dictate the U.S. foreign policy approach to relationships with these countries.

STRENGTHEN U.S.-INDO TIES AND STRENGTHEN INDIA

The United States wants to separate its relationship with Pakistan and India so that it can strengthen ties with each. Over the past year, President Bush has moved to enhance India’s and the United States’ positions as natural allies on the world stage. In our meetings with U.S. Embassy staff, the political officer referred to the introduction of a “new paradigm” of Indo-U.S. relations, characterized by increasing cooperation. This relationship is important to the United States in order to provide a balance of power in Asia and to support the administration’s belief in promoting democracy throughout the world. To that end, the United States has moved to bring India back within the international nuclear regulatory framework for the first time since the first Indian nuclear bomb in 1974, and to lay the groundwork for supporting India’s bid for a seat on the United Nations Security Council.

It is within this context that the administration’s plan to help India with nuclear power and achieve greater military coordination makes sense. Announced jointly with Prime Minister Singh in July 2005 as the Next Step Strategic Partnership, the plan is for the United States to share civilian nuclear technology with India in exchange for India’s agreement to submit

its civilian facilities to international monitoring, and to cooperate on military operations and technology. The agreement has caused a stir in the international community because it violates the terms of the NPT. Yet manufacturers in the United States are excited about the possibility. In February 2005, Boeing, along with Lockheed Martin and Northrop Grumman “showed them the good stuff” at a defense exposition held in Bangalore in pursuit of cementing their interests in selling aircrafts to the quickly growing domestic airline, Air India.⁵⁴

The plan has been presented as an important step in improving India’s energy security, and steering India away from strange political bedfellows in search of oil and gas. But nuclear power comprises a tiny, though growing, portion of India’s energy needs – expanding nuclear production might not crack India’s top five priorities in reforming its dysfunctional energy sector. So why does the administration want to modify the NPT, a more or less effective deterrent to nuclear development in other developing countries such as Brazil and South Africa? The answer is that President Bush wants to build a strong ally in Asia despite the political cost. While it remains to be seen whether President Bush and Prime Minister Singh can convince their respective legislatures to go along with the deal, the fact that it is a serious consideration underlines India’s strategic importance to the United States.

An NPT carve-out for India would not only formalize India’s existing nuclear situation in an official framework, but would also pave the way for the U.S. to publicly pledge support for India’s bid for a coveted permanent seat on the UN Security Council. Though India’s new status as the U.S.’s ‘strategic partner’ might imply U.S. backing of India for UN Security Council seat, the U.S. has been silent on the issue. Until now, the U.S. has only pledged its support for Japan, which meets the criteria enumerated in its own reform proposal to the Security Council. Complicating the decision, Pakistan has an interest in blocking U.S. support for India, as it views such a move as a potential threat to its own relationship with the United States. At this time, however, the U.S. should (and will) continue its efforts to stall the UN resolution process until movement has been made on this domestic front, at which point it should be better poised to back both Japan and India as part of its own reform proposal. This strategy would best advance U.S. foreign policy interests in achieving a balance of power in Southeast Asia, but would limit the dispersion of power such that the U.S. preserves maximum leverage in the UN Security Council.

DO NOT ‘PLAY TO THE GALLERY’ WITH TRADE POLICY

On issues of trade, the two countries have become increasingly linked over the past decade, as a post-reform India has opened its economy. In addition to greater movement of goods and services, the U.S. and India increasingly share important bonds in the sheer number of people that cross between the economies. Since 1994, Indians have obtained the most H-1B visas in the United States, which permit highly skilled workers to remain in the U.S. for up to six years. Recently, Indians have also taken the lead in the number of students sent to America, outnumbering Chinese students for four consecutive years.⁵⁵ Both these factors contribute to the growing influence of Non-Resident Indians in both the U.S. and Indian business communities. *BusinessWeek* reported in 1998 that nearly 40% of Silicon Valley startups in the 1990s had at least one founder of Indian origin.⁵⁶ While recent U.S. policies

have discouraged many foreign nationals from working or studying in America, the numbers continue to increase for India. This is partially due to the relatively friendly policy stance toward Indian nationals.⁵⁷ Just as important, India is one of the few remaining countries whose citizens give the U.S. a positive approval rating – 71% of Indians rated America favorably in 2005.⁵⁸

Despite the many links that tie the U.S. and India together economically and socially, the debate over offshoring and outsourcing (referred to here collectively as “sourcing”) is the one trade issue that threatens to disrupt the continuing improvement in U.S.-Indian relations. A heated topic during the 2004 elections, recent poll data revealed that the sourcing of jobs overseas by American firms remains “the foreign policy that most upsets Americans” – 78% of Americans recently gave the U.S. government an unfavorable rating for its inability to “protect U.S. jobs from moving overseas.”⁵⁹ In the United States, policymakers have learned they must watch their steps when dealing with this divisive issue.

Sourcing, like all trade that occurs in competitive markets, provides an overall benefit to the economy, but it also produces individual winners and losers. The obvious winners are U.S. firms (and their shareholders) that maintain their competitiveness in both domestic and international markets. Less visible are the tangential benefits to the American economy. The cost efficiencies of sourcing keep prices lower for U.S. consumers. Furthermore, trade with an open India has created new demands for American products. At its main campus in Bangalore, Infosys employees work on Dell computers, drive Ford automobiles, drink Coca-Cola, and eat at the busiest Domino’s Pizza franchise in India.

Recent attention to sourcing has overstated its negative aspects. While some U.S. workers have lost their jobs, the scale of losses due to sourcing is small compared to normal domestic employment turnover, and likewise small compared to the number of jobs lost because of technological improvements. Indeed, the types of jobs lost to sourcing are also the same jobs most vulnerable to automation. The reason sourcing has become such a contentious political issue is not because the U.S. economy is suffering, but because the gains from sourcing are not sufficiently being shared among those who unfortunately lose employment. There are several policy strategies the federal government could pursue to give these displaced workers a “softer landing,” and more importantly, to help them develop new skills and find new jobs. In addition, the U.S. should make concerted efforts to provide greater investment in education and research in order to foster innovation and continue to create the high-quality jobs that spur American economic growth, as suggested recently by the National Academy of Sciences.⁶⁰

While a nuanced policy approach to sourcing is necessary to ensure the gains are distributed fairly, some American leaders have found it easier to blame sourcing for political gain. The outlook in India is that these uproars will come and go with election cycles, without threatening the economic relationship between the two countries. The CEO of Infosys, Nandan Nilekani, dismissed outsourcing backlash as a non-issue for his company. Milind Deora, Member of Parliament (MP) from Mumbai, stated that a delegation of U.S. Congressmen in 2004 explained their election rhetoric by assuring him that, “we had to play to the gallery.” It is in the best interests of the United States to ensure

that the challenges of sourcing are met with sensible policies, not protectionist impulses that may secure votes in the short-term, but may jeopardize an important blooming relationship with India.

CONCLUSION

The “new paradigm” of U.S.-Indo relations is still very young. The Cold War ended less than two decades ago, around the same time as India’s economic liberalization began. In that short span, the two countries have made great strides toward cooperation. Improving U.S.-India relations have only gathered momentum over the past few years, due to the thawing of Cold War suspicions, the improvement of information technology and the U.S. need for skilled engineers in response to Y2K, and efforts by both American and Indian administrations to establish better relations.

The United States has the opportunity to pursue policies that will continue to benefit its long-term economic and geopolitical interests. Treating India and Pakistan independent of each other will allow America to develop strategic relationships with both nations. Strengthening U.S.-India cooperation on military and energy issues can provide both countries with valuable allies in international affairs. Finally, keeping economies open will deepen the economic ties that benefit both countries.

The United States and India simply have too much in common not to develop a deep, mutually beneficial partnership: both are democracies, with open economies and diverse populations, which seek to contain China’s ambitions and fight terrorism in Asia. In short, the U.S.-India relationship, as MP Milind Deora stated to our group, “is here to stay.” The outlook for cooperation is quite good, and the policies we recommend will ensure that the relationship grows in ways that continue to benefit American economic and international interests over the coming years.

VIII. CONCLUSIONS

The Slow Death of an Autarky

Watching India's economy is both an exhilarating and frustrating pastime. It's exhilarating because a massive country with a great number of the world's poor now has one of the world's highest economic growth rates. It's frustrating because, during this period of unique opportunity, the growth is not what it could be. Sadly, many of the recommendations in this report would have been made five years ago. To be sure, progress has been made, and a broad consensus about required reforms has emerged across the major political parties. But politics, entrenched opposition, and the status quo usually prevail – and India's dreary public health statistics are but one grim reminder of the challenges ahead.

The country is still suffering the hangover of a tough 20th century – half spent in exploitative colonial rule and half spent in an autarkic, socialist economy. Its economic growth rate of 7% sounds impressive until one realizes that India is starting from an absurdly low base and has the potential for 4-5% more in annual growth. If India is in an economic race, it is gaining so much ground only because it spent fifty years running with both hands tied behind its back. Thanks partly to the crisis in 1991, the economy now has one hand free. We can only imagine and hope for the social progress that will come if the Indian people allow themselves to shake off the remaining constraints and charge full speed ahead.

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⁵ Tharoor, 174.

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⁷ Tharoor, 175

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