Backgrounder

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What Indian Economic Reform Could Mean for the U.S.

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Abstract: *Summer 2011 marks the 20th anniversary of major market reforms in India. Unfortunately, reform is no longer progressing, which is harming the Indian economy. The reform halt has also greatly inhibited the development of the U.S.–India economic relationship, so that it remains far from achieving its unmatched potential. To address inflation and other major problems, India should turn away from the state and back to the market to lead development. If this happens, there are a range of steps the U.S. can then take to greatly enhance the bilateral economic relationship.*

Talking Points

- On the 20th anniversary of major Indian economic reforms, reform has all but stopped. Partly because of this, the U.S.–India economic partnership is woefully underdeveloped, far from reaching its potential as a globally vital relationship.
- American policy cannot move aggressively forward in engaging India economically until India restarts its market reform.
- Moving away from the state and back toward the market would help India reduce inflation, genuinely improve its infrastructure, and increase the agricultural productivity that is necessary for development.
- If India re-embraces reform, the U.S. should offer to greatly expand the bilateral investment and trade relationships, including protections for Indian workers in the U.S. and the start of negotiations for a free trade agreement.
- If India re-embraces reform, the U.S. should seek Indian cooperation in finally concluding the WTO Doha round and should promote full Indian participation in APEC and similar regional forums.

This paper, in its entirety, can be found at: *http://report.heritage.org/bg2598*

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From the vantage point of 2008, the summer of 2011 looked very promising. In India, it would be the 20th anniversary of the country's 1991 economic reforms. These market reforms had propelled the economy far past the "Hindu rate of growth"—shorthand for the trickle of growth under a series of socialist governments. For the U.S.–India relationship, a new era of commercial cooperation stemming from the bilateral nuclear agreement seemed possible.

The reality of summer 2011 is far less promising. Market reform has faded almost to the point of invisibility in India at the national level, and relying on the notoriously inept Indian state to lead development is having unpleasant results. The U.S.–India relationship faces a number of obstacles, but all would be easier to negotiate if the truly unmatched potential of the economic relationship was being realized.

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There is a gigantic gap between the current level of U.S.–India cooperation and the level that could be possible with renewed vibrant Indian economic reform. India should restart reform for its own reasons, but the U.S. must match its own policy to the reality of the situation, not what India should do. If India again moves forward, the sky is the limit. Until India does move forward, though, the bilateral economic partnership has comparatively minor value.

How India meets challenges such as inflation and low agricultural productivity will determine the path for the economic partnership. American policy should be guided by two very different sets of recommendations, with the far more attractive set conditional on India re-embracing reform.

U.S. and India: Global Perspective

Combined U.S.–India share of 2010 world GDP	25.5%
Combined U.S.–India share of 2010 world population	21.9%
Bilateral U.S.–India trade share of 2010 world trade in goods*	0.2%
Bilateral U.S.–India investment share of 2009 world direct investment**	0.5%

* Services trade would expand the share, but global services trade data are poor.
** Latest data available.

Sources: See Footnote 1.

Table 1 • B 2598 heritage.org

Mutual Underperformance

The current condition of U.S.–India economic relations can reasonably be characterized as improving, but from a very poor base. The bilateral partnership has truly staggering potential, but that potential is far out of reach.

In 2010, India and the U.S. combined accounted for over one-fourth of global GDP and more than one-fifth of the world's population. Yet bilateral goods trade between the two countries was less than 1 percent of world trade in goods. Direct investment varies more than trade on an annual basis, but the most recent bilateral share of world investment is also less than 1 percent.

These numbers are stunning. India retains notable barriers to trade and investment but has dramatically changed its policies in the past 20 years and is hardly an isolated economy. In addition to policy, trade is about the endowments and ensuing comparative advantages of two economies. The U.S. is, in principle, land rich, capital rich, and labor poor—it has relatively more capital and land available for production than labor. India is labor rich, land poor, and capital poor. The two countries should be perfect complements.

Moreover, India's neighbors are limited economic partners, which should make Indian trade and investment more global in nature. Yet the volume of bilateral trade was only $48 billion last year, so that India (population 1.18 billion) lagged Taiwan (population 23 million) as an American trade partner in both exports and imports.[2]

Perhaps worse, U.S.–India trade was led, in both directions, by jewelry. This indicates that comparative advantage is being ignored. Free trade would be led by grain or capital-intensive equipment on the American side and labor-intensive, broad-use consumer goods on the Indian side.[3] Perhaps the most promising area for trade is defense, but it is driven

1. Central Intelligence Agency, *The World Factbook*, July 15, 2011, at *https://www.cia.gov/library/publications/the-world-factbook/geos/xx.html* (August 2, 2011); U.S. Census Bureau, International Trade Statistics, at *http://censtats.census.gov/naic3_6/naics3_6.shtml* (August 2, 2011); press release, "Trade Growth to Ease in 2011 but Despite 2010 Record Surge, Crisis Hangover Persists," World Trade Organization, April 7, 2011, at *http://www.wto.org/english/news_e/pres11_e/pr628_e.htm#atable1* (August 2, 2011); The World Bank, "World Development Indicators," April 2011, at *http://data.worldbank.org/data-catalog/world-development-indicators?cid=GPD_WDI* (August 2, 2011); U.S. Department of Commerce, Bureau of Economic Analysis, "U.S. Direct Investment Abroad: Country and Industry Detail for Financial Outflows," 2011, at *http://www.bea.gov/international/xls/usdiacap.xls* (August 2, 2011); and Organization for International Investment, "Foreign Direct Investment in the United States," March 18, 2010, at *http://www.ofii.org/docs/FDIUS_2010.pdf* (August 2, 2011).
2. U.S. Census Bureau, "Foreign Trade Statistics," December 2010, at *http://www.census.gov/foreign-trade/statistics/highlights/top/top1012yr.html* (August 2, 2011).

by security needs, and again not by comparative advantage.

American direct investment in India is less than 2 percent, annually, of total American investment overseas. This can change; Abbott Labs bought Piramal Healthcare for $3.7 billion in May. To extend Abbott's success will require a more open Indian market. Indian direct investment in the U.S. is wildly uneven. It fell to almost zero in 2009 but, when the final figures are in, may set a record for 2010, driven by multiple large purchases by Reliance Industries[4] in the energy sector. Such purchases can and should become the norm.

It is certainly not the case that bilateral trade and investment shares should match the combined GDP or population shares. U.S.–India goods trade could easily be five times larger than it is, based on the size of the two economies and their complementary natures. Bilateral investment flows could quickly double to past $10 billion annually and hold that level, with more from the U.S. but a sizable volume from India. This is how much mutually beneficial exchange the U.S. and India are missing.

Limited Partnership

The unnecessarily thin economic ties limit the motives and opportunities for cooperation. The globalization of the Indian economy calls for good financial coordination between the Reserve Bank of India and the U.S. Federal Reserve, which seems to be occurring.

On a bilateral basis, the infrequent but sizable acquisitions suggest the value in greater understanding of legal and regulatory frameworks, especially at the state levels. American states add a layer of oversight that Indian investors should anticipate. Indian states vary wildly as operating environments,[5] and more direct contact by both companies and the U.S. government would yield much better-informed investment decisions.

The grand achievement of a bilateral investment treaty (BIT), however, is well off in the distance. Given the limited volume of two-way investment, the incentive to move quickly on a BIT is small. Moreover, as sketched below, India must undertake fundamental reforms prior to a truly valuable BIT. At present, only a symbolic agreement would be feasible, and that could unwisely inhibit reaching a substantive treaty later.

Energy trade and investment have encountered major obstacles but can be extended in certain directions. India and the U.S. are leading coal producers and should be able to cooperate at both the government level, through joint research, and the corporate level, through industry integration, to improve the production process.

Indian demographic expansion could either harm India or tremendously benefit India, as well as the U.S., depending on how well-educated and -trained the new Indian workers will be.[6] In light of this, it would be best if the two sides could work together on primary and secondary education. If Indian politics blocks cooperation in basic education, there is still room for far greater cooperation in higher education.

Bilateral trade is underdeveloped but should grow of its own accord as the Indian economy expands and globalizes, assuming the U.S. avoids serious protectionism. It would be helpful if the U.S. restored the suspended Generalized System of

3. U.S. Census Bureau, "International Trade Statistics," at *http://censtats.census.gov/naic3_6/naics3_6.shtml* (August 2, 2011).
4. "Abbott Labs to Buy Piramal Domestic Formulation Business for $3.72 Billion; to Become Number One Drugmaker in India," *The Pharma Letter*, May 21, 2010, at *http://www.thepharmaletter.com/file/95185/abbott-labs-to-buy-piramal-domestic-formulation-business-for-372-billion-to-become-number-one-drugmaker-in-india.html* (August 2, 2011), and Rakteem Katakey, "Reliance Industries Buys Eagle Ford Stake From Pioneer for $1.3 Billion," Bloomberg, June 24, 2010, at *http://www.bloomberg.com/news/2010-06-24/pioneer-sells-stake-in-eagle-ford-to-reliance-industries-for-1-15-billion.html* (August 2, 2011).
5. "Maharashtra, NCR Got Over 50% of FDI in First Half of 2010–11," Press Trust of India, December 28, 2010, at *http://www.business-standard.com/india/news/maharashtra-ncr-got-over-50fdi-in-first-half2010-11/419823/* (August 2, 2011).
6. Derek Scissors and Michelle Kaffenberger, "U.S.–India Relations: Ensuring Indian Prosperity in the Coming Demographic Boom," Heritage Foundation *Backgrounder* No. 2274, May 15, 2009, at *http://www.heritage.org/Research/Reports/2009/05/US-India-Relations-Ensuring-Indian-Prosperity-in-the-Coming-Demographic-Boom*.

Preferences (GSP) trade access,[7] where perhaps an Indian trade liberalization step could help nudge the American political process forward.

The potential for multilateral cooperation—at the World Trade Organization (WTO), the Asia–Pacific Economic Cooperation (APEC) Forum, and in ASEAN-centered forums—is considerable, but India's present disinterest in market reform is a major obstacle. As consumption-driven economies, the U.S. and India should be in fundamental accord at the WTO; instead, bilateral differences are the single biggest reason for the most recent failure of the Doha round. Including India in APEC should be considered an exciting possibility for expansion but is instead viewed as bringing in a country that might effectively block regional integration.[8]

India Needs Reform

The U.S. is certainly not blameless in the relative absence of trade and investment, but the much more important obstacle is the failure of Indian reform. India needs reform for itself, not for its relationship with the U.S., but an exceptional partnership for America and India will only come with economic change within India.

India has had several rounds of reform, beginning in the 1980s, followed by the headline reform of the early 1990s, and another wave cresting about 2002.[9] Since then, however, Indian statism has reemerged and the economy has increasingly moved in the wrong direction. This was masked initially by gains from previous reforms and global loose money, but the mask is off and the Indian economy is now structurally weaker than it was a few years ago.

The signs of this weakening are disturbing. India ranks 164th in business freedom of the 179 economies graded in The Heritage Foundation/Wall Street Journal *Index of Economic Freedom*.[10] The local and global business communities have voted with their feet. In fiscal year (FY) 2010–2011, outward investment more than doubled while inward investment plunged, leading to a $20 billion net outflow from an economy that needs investment.[11] Related but even worse, rapid GDP growth is not expanding employment nearly as much as it should. There is even the possibility that labor force participation is declining.[12] This is a dire threat given demographic expansion.

There are multiple reasons for structural weakness, but they all stem from an effective renunciation of improved efficiency and productivity as the driving force for growth, in favor of state control and mobilization of resources. This has led to gigantic amounts of wasted resources, geographic and sector distortions, and the current battle with inflation.

Inflation

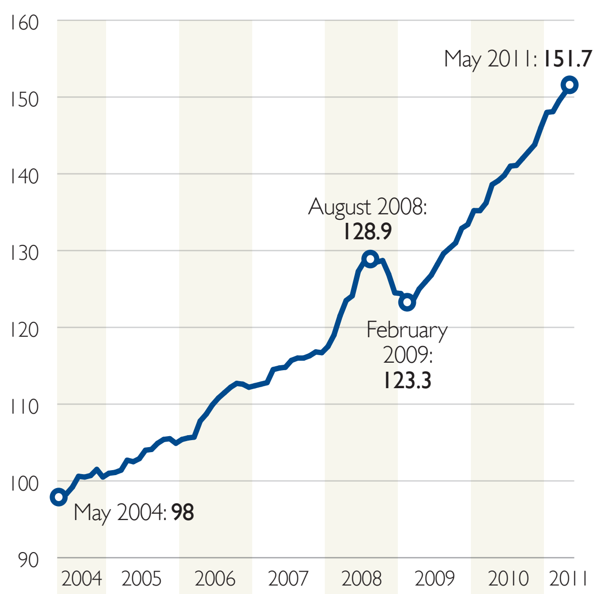
Inflation is too much money chasing too few goods and services. State-led growth relying on loose

7. Amiti Sen, "India Appeals to U.S. Senators for Revival of Duty-Free Imports," *The Economic Times*, July 13, 2011, at *http://articles.economictimes.indiatimes.com/2011-07-13/news/29768917_1_duty-free-imports-duty-free-imports-gsp-scheme* (August 2, 2011).
8. Jagdish Bhagwati and Arvind Panagariya, "Doha: Why the Key to Its Success Lies in Washington," *Vox*, July 9, 2007, at *http://www.voxeu.org/index.php?q=node/371* (August 2, 2011), and "India APEC Membership May be Years Away," Reuters, December 26, 2007, at *http://www.financialexpress.com/news/india-apec-membership-may-be-years-away/254493/* (August 2, 2011).
9. T. N. Srinivasan and Jessica Wallack, "India's Economic Development Strategy and Economic Reforms: A Political Economy Perspective," Indian School of Business, at *http://www.isb.edu/Faculty/upload/Doc291220091521.pdf* (August 2, 2011).
10. Terry Miller and Kim R. Holmes, *2011 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2011), at *http://www.heritage.org/index*.
11. James Fontanella-Khan, "When India's Money Men Take Flight," beyondbrics, *The Financial Times* blog, July 7, 2011, at *http://blogs.ft.com/beyond-brics/2011/07/07/india-no-country-for-domestic-investments/#axzz1TnCoeItw* (August 2, 2011), and Government of India, Ministry of Commerce and Industry, Department of Industrial Policy & Promotion, "Fact Sheet on Foreign Direct Investment (FDI) from August 1991 to March 2011," at *http://dipp.nic.in/fdi_statistics/india_FDI_March2011.pdf* (August 2, 2011).
12. C. P. Chandrasekhar and Jayati Ghosh, "Deciphering Employment Trends," *The Hindu Business Line*, July 26, 2011, at *http://www.thehindubusinessline.com/opinion/columns/c-p-chandrasekhar/article2293456.ece?homepage=true* (August 2, 2011).

monetary and fiscal policy has generated too much liquidity. Low productivity from lack of reform has limited the quantity of goods and services.

In India's case, inflation starts with bad fiscal policy. High growth should permit budget surpluses, but India has maintained a large deficit for years. The cumulative failure is reflected in the share of government spending devoted to interest payments for the debt, which is approaching 20 percent. The share of revenue, of course, is yet higher. The supposed improvement in the current budget stems largely from unrealistic assumptions, such as an inflation rate of merely 5 percent for 2011–2012.[13]

Indian Wholesale Price Inflation



Source: Reserve Bank of India, Database on Indian Economy: RBI's Data Warehouse, at *http://dbie.rbi.org.in/InfoViewApp/listing/main.do?appKind=InfoView&service=%2FInfoViewApp%2Fcommon%2FappService.do* (July 27, 2011).

Chart 1 • B 2598 heritage.org

Because the government's interest payments are so large, rates have been kept dangerously low. Even after a series of rate increases, the return on deposits was only 4 percent, and borrowing costs for the best borrowers only 7 percent at the end of June. Inflation was at least 9 percent, so that real borrowing costs (for some) are negative and the real return on savings is steeply negative.[14]

The stark tilt in favor of the government adds to the distortions that always come from negative real interest rates. The absence of reform has led to financial market segmentation,[15] so that the government pays nothing to borrow while many firms face much higher rates.

Money supply has developed exactly as to be expected with negative real rates. From March 2005 to March 2010, GDP grew by half, but the broadest measure of money supply ballooned one and a half times. For FY 2010–2011, credit growth accelerated sharply past 22 percent.[16] This is a clearly unsustainable pace of expansion. It has occurred because the state has sought to maintain high growth without making politically difficult reform decisions.

The inevitable outcome is inflation. Wholesale prices rose 9.4 percent on-year in June, again accelerating. The situation is probably worse than that—previous inflation numbers have all been revised higher. In FY 2010–2011, an 8.4 percent nominal pay increase badly lagged 12.3 percent consumer inflation, so that real incomes dropped.[17]

The absence of reform and subsequent reliance on unsustainable stimulus also explain Delhi's

13. "Where Does the Budget Rupee Come from, Where Does It Go?" *The Times of India*, February 28, 2011, at *http://timesofindia.indiatimes.com/home/union-budget-2011/Where-does-the-Budget-rupee-come-from-where-does-it-go/articleshow/7594948.cms* (August 2, 2011).
14. James Fontanella–Khan and Amy Kazmin, "India Lifts Rates to Curb Inflation," *The Financial Times*, May 3, 2011, at *http://www.ft.com/intl/cms/s/0/c5c370b4-754f-11e0-8492-00144feabdc0.html#axzz1TnFGlpOv* (August 2, 2011).
15. R. H. Patil, "Broadbasing and Deepening the Bond Market in India," The Wharton Financial Institutions Center, May 26, 2005, at *http://fic.wharton.upenn.edu/fic/papers/01/0132.pdf* (August 2, 2011).
16. A. Seshan, "No Baby Steps This Time," *The Hindu Business Line*, April 27, 2011, at *http://www.thehindubusinessline.com/opinion/columns/a-seshan/article1770357.ece* (August 2, 2011), and C. P. Chandrasekhar and Jayati Ghosh, "India's Schizophrenic Banks," *The Hindu Business Line*, June 28, 2011, at *http://www.thehindubusinessline.com/opinion/columns/c-p-chandrasekhar/article2139495.ece?homepage=true* (August 2, 2011).

abysmal reaction to inflation. Starting in fall 2009, top officials have repeatedly insisted that inflation would soon fall to 6 percent, first by March 2010, then by March 2011, and now by March 2012. Both wholesale and consumer inflation reached double digits during this period, never for a moment falling as low as 6 percent.[18]

Because the national government's economic policy requires fiscal and monetary excess, the leadership has little choice but to fall back on claims that relief is around the corner. Eventually, the rate of inflation must fall simply because base prices have become so high. This will hardly come as a relief. Reform is a far better alternative. It can substitute for expansionary policy and thus neutralize inflation indefinitely.

Infrastructure

State-led infrastructure development is the centerpiece of economic policy. It shows just as clearly as monetary and fiscal policy the utter failure of the state in spurring growth in sustainable fashion. At the most general level, driving growth with spending crowds out labor in favor of capital and limits job gains.

The details of the infrastructure program are just as ill-considered. A $500 billion infrastructure spending goal in the current five-year plan is likely to be met, but this success obscures a string of prohibitive failures. The target would not be met without telecom, a sector now vilified as the root of corruption. The private component of infrastructure investment is almost entirely in telecom.[19]

Elsewhere, the situation is ugly. Private firms are contributing about 17 percent of the $500 billion, overall. The government is planning for $1 trillion more in infrastructure investment between 2012 and 2016, half from the private sector.[20] This would be nearly a six-fold increase in the quantity of private spending, to occur as the government legally assaults telecom firms, the biggest private participants. It is unrealistic to the point of fantasy.

The continuing appeals to foreign investors are almost as unrealistic. Multinationals' stake in public–private infrastructure partnerships is negligible, despite proffered incentives. A higher cap in infrastructure for foreign institutional investors induced no response at all.[21]

Private investors, both domestic and foreign, have good cause for skepticism. Rather than improving performance, greater infrastructure spending is associated with less efficiency. The percentage of large projects in core sectors behind schedule increased from one-third in March 2007 to more than half in December 2010. The target for new seaport capacity in the present five-year plant is likely to be only one-third filled.[22]

Electric power is perhaps the most dire need. The previous five-year plan saw additional power capacity fall short of the target by half. The current

17. "June Inflation Jumps to 9.44%, May Trigger Rate Hike," *The Economic Times*, July 15, 2011, at *http://economictimes.indiatimes.com/news/economy/indicators/june-inflation-jumps-to-944-may-trigger-rate-hike/articleshow/9229904.cms* (August 2, 2011), and Vivek Sinha and Shikha Sharma, "Real Income of Salaried Falls First Time in Five Years," *The Economic Times*, May 11, 2011, at *http://articles.economictimes.indiatimes.com/2011-03-11/news/28680348_1_consumer-inflation-salary-consumption-expenditure* (August 2, 2011).

18. Subodh Varma, "Does the Government Know How to Control Rising Prices?" *The Times of India*, July 29, 2010, at *http://articles.timesofindia.indiatimes.com/2010-07-29/india/28284495_1_price-rise-wholesale-prices-food-prices* (August 2, 2011), and "Inflation Likely to Go up Further: Economists," *Press Trust of India*, July 13, 2011, at *http://www.thestatesman.net/index.php?option=com_content&view=article&id=376437&catid=40* (August 2, 2011).

19. "Infra Spending to Be Close to Plan Target of $500 bn: Montek," *The Economic Times*, September 20, 2010, at *http://articles.economictimes.indiatimes.com/2010-09-20/news/27572677_1_investment-target-ppp-mode-12th-five-year-plan* (August 2, 2011).

20. "India Sees Jump in Private Funding for Infrastructure," Reuters, April 16, 2010, at *http://www.livemint.com/2010/04/16171319/India-sees-jump-in-private-fun.html* (August 2, 2011).

21. S. Arun, "Foreign Equity Minuscule in Public–Private Projects," *The Hindu Business Line*, December 24, 2009, at *http://www.thehindubusinessline.com /2009/12/25/stories/2009122553300100.htm* (August 2, 2011), and Ruchira Roy, "Higher FII Cap Fails to Fire Infra Bonds," *The Economic Times*, July 4, 2011, at *http://economictimes.indiatimes.com/news/economy/policy/higher-fii-cap-fails-to-fire-infra-bonds/articleshow/9092480.cms* (August 2, 2011).

plan has already seen the target cut by more than 20 percent and probably will not achieve even the reduced goal. Nonetheless, hydroelectric projects have been exempted from competitive bidding,[23] and the solution is supposed to be more government involvement.

But the worst performance is in roads. Only about 12 kilometers of new road per day is being built, instead of the 20-kilometer-per-day target, and progress is slowing. More than two-thirds of National Highway Authority projects have been delayed. Incredibly, less than 40 percent of planned outlays on road construction are being used.[24] The principal problem for all sorts of investors in road projects—foreign and domestic, public and private—is land acquisition, which stems from extremely weak property rights for land.

Agriculture

Inflation is India's biggest short-term problem, and the remarkable mismanagement of infrastructure its biggest medium-term problem. But the biggest long-term problem is still agriculture. Indian development must ultimately include much higher rural wealth and much more urbanization. Both stem from higher agricultural productivity. Without higher agricultural productivity, economic development will eventually stall.

The Indian government is not trying to increase agricultural productivity; it is actively undermining it. Some food subsidies may be necessary, but their explosive expansion—doubling in the past two fiscal years—decreases agricultural efficiency. That the programs are themselves horribly wasteful makes matters worse.[25] Individual states inflict additional harm by blocking farm products from other states and preventing those with a comparative advantage in agriculture from serving the rest of the country.

It is therefore not a surprise the Reserve Bank of India found that from 1997–2005 agricultural productivity actually dropped slightly.[26] This is almost incomprehensible given India's stage of development and speed of GDP growth. It will devastate long-term development prospects if sustained.

While national and state governments cause pain, the market offers the balm: sharper property rights. It is universally accepted that by far the greatest asset the rural poor have is their land. In India, rights to that land are attenuated.[27]

One problem is contested ownership among locals. Another is the state role—in principle, the state owns assets associated with land, such as minerals, but the concept of "state" is notoriously unclear. The result is that ownership is contested when domestic companies, multinationals, or

22. Ravish Tiwari, "53% Infrastructural Projects Delayed," *Indian Express*, May 30, 2011, at *http://www.indianexpress.com/news/53-infrastructural-projects-delayed/797069/* (August 2, 2011).

23. "India May Miss Power Capacity Addition Target," *The Financial Express*, June 22, 2010, at *http://www.financialexpress.com/news/india-may-miss-power-capacity-addition-target/637074/* (August 2, 2011), and "No Tariff-based Bids for Hydro, Transmission Projects," *Indian Express*, July 1, 2011, at *http://www.indianexpress.com/news/no-tariffbased-bids-for-hydro-transmission/811319/* (August 2, 2011).

24. Sujay Mehdudia, "Top Priority for Infra Projects," *The Hindu*, February 26, 2011, at *http://www.thehindu.com/business/Economy/article1490297.ece* (August 2, 2011); Infra Projects Under New Purview," *Live Mint*, May 17, 2010, at *http://www.livemint.com/2010/05/17223810/Infra-projects-under-new-purvi.html* (August 2, 2011); and Geeta Anand, "Indian Road Hits Unexpected Bump," *The Wall Street Journal*, September 7, 2010, at *http://online.wsj.com/article/SB10001424052748703369704575461622844955894.html* (August 2, 2011).

25. "Food Subsidy Bill to Rise by 27% to Rs 74,231 Cr," *The Financial Express*, February 22, 2011, at *http://www.financialexpress.com/news/food-subsidy-bill-to-rise-by-27-to-rs-74-231-cr/753379/* (August 2, 2011), and M.R. Subramani, "Study Finds Large Diversion of Rice, Wheat from PDS, Welfare Schemes," *The Hindu Business Line*, September 22, 2010, at *http://www.thehindubusinessline.com/todays-paper/article1004781.ece* (August 2, 2011).

26. "Reforms Haven't Helped Productivity, says RBI," *The Economic Times*, August 25, 2010, at *http://articles.economictimes.indiatimes.com/2010-08-25/news/27629354_1_rbi-deputy-governor-central-bank-subir-gokarn* (August 2, 2011).

27. Sanjeev Choudhary and James Pomfret, "CORRECTED-FEATURE–Land, Votes and Progress at Stake in India's Property Crunch," *Reuters*, July 27, 2011, at *http://af.reuters.com/article/metalsNews/idAFL3E7IN05N20110727* (August 2, 2011).

even the government wants to buy.[28] Among other things, this explains why there are large Indian industrial firms but no large Indian agriculture firms: Property rights are much clearer in industry than agriculture.

The power of sharper property rights has been clearly demonstrated by India's chief economic competitor. When China initiated reform in late 1978, it was no richer than India. China's success since has been based first and foremost on explosive growth in agricultural productivity and wealth in the 1980s, which stemmed from granting additional property rights to farmers.[29] In agriculture, as in infrastructure and other policies, the notion that stronger government action is the cure to what ails India is horribly wrong. The cure is more economic freedom and less government infringement.

Ten Drug Patent Rejections in Six Months

From December 30, 2010 to June 30, 2011

Company	Headquarters	Drug
Abbott	U.S.	Kaletra
Bayer	Germany	Yaz
Bayer	Germany	Yasmin
Bristol-Myers Squibb	U.S.	Reyataz
Helsinn	Switzerland	Aloxi
Novartis	Switzerland	Tekturna
Novartis	Switzerland	Valturna
Novartis	Switzerland	Deferasirox
Pfizer	U.S.	Chantix/Champix
Therevance	U.S.	Vibativ

Source: IHS Global Insight, Country and Industry Forecasting, "Multinationals Hit by Series of Indian Patent Office Rejections," January 14, 2011, at *http://www.ihs.com/products/Global-Insight/industry-economic-report.aspx?ID=1065928681* (August 5, 2011).

Table 2 • B 2598 heritage.org

Harming Bilateral Relations

India's economic relationship with the U.S. is obviously far less important than India's own economy but is perhaps equally affected, directly and indirectly, by the recent re-embrace of statism.

The general waste of resources and failure to progress in the market transformation of agriculture bars India's realization of its full development potential, and thus the potential of its U.S. economic ties. It also indirectly inhibits American farm and other exports, as various sectors of the Indian economy are thought to need shelter from foreign competition, when they instead need internal reform to avoid stagnation.

Both inflation and government control of infrastructure programs discourage American investors. They probably encourage Indian investment in the U.S. but, when motivated by inflation and state intervention, this money is less seeking mutually beneficial opportunity in America and more simply leaving India.

There is additional harm from attenuated property rights. American pharmaceutical companies have repeatedly seen patents rejected by the Indian Patent Office or left unprotected by Indian courts, leaving local firms free to manufacture generics when they should have no right to do so. These are openly self-serving decisions that defy international standards and benefit Indian companies at the expense of foreign companies. They are not made on purely mercantilist impulses, but because government officials believe they must act to keep prices low.[30]

This is the same short-sightedness as in the case of weak land rights. Not giving full rights to the owners of land or knowledge may seem as if it decreases the price for purchasers, but it also ensures underdevelopment, in this case of drugs tailored to India's specific and pressing needs.

28. "India's Lingering Leviathan," *The Wall Street Journal*, March 1, 2011, at *http://online.wsj.com/article/SB10001424052748704615504576172013791797534.html* (August 2, 2011).

29. Barry Bosworth and Susan M. Collins, "Accounting for Growth: Comparing China and India," *Journal of Economic Perspectives*, Vol. 22, No. 1 (Winter 2008), pp. 45–66, at *http://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.22.1.45* (August 2, 2011), and Yasheng Huang, *Capitalism with Chinese Characteristics* (New York: Cambridge University Press, 2008).

There is also direct harm to the bilateral relationship from Indian government intervention into markets. The obvious form is trade protectionism. Energy cooperation is supposed to be a staple of the relationship yet India bars all imported solar panels. In nuclear energy, it has crafted more regulations that do not meet global standards, this time concerning supplier liability. These inhibit participation by American companies, though it was the U.S. that enabled India to access foreign nuclear technology.[31]

Foreign investment is heavily restricted in sectors ranging from railways to retail. Multinationals without local partners are not eligible for most government contracts.[32] Recent legal clashes with Vodafone and other companies indicate that New Delhi still considers the chief role of multinationals to be enhancing government revenue, rather than enhancing the goods and services available to ordinary Indians.

The movement of labor has also been targeted. India complains, correctly, about arbitrary and unwise American visa restrictions, but is quite willing to apply its own. Foreigners can only comprise 1 percent of the workforce or 20 employees, whichever is higher.[33]

Extending Cooperation

It could require multiple books to document the possible areas for market-oriented Indian reform. The bottom line is that a renewed Indian willingness to reduce state involvement would transform U.S.–India economic discussions and greatly enhance the potential for a partnership. The much greater benefit would accrue to India, but benefit could also accrue to the U.S.

As an especially sharp example, ending the discouragement or outright ban of American investment in some sectors could bring a wave of benefits. For the U.S., a reforming India is an unparalleled opportunity—an economy that can grow quickly for a full generation and is consumption-oriented rather than production-oriented, as in East Asia.

For India, gains would be many. As a new growth engine, American (and other foreign) investment would reduce the pressure for misguided use of government spending to spur growth, thus reducing borrowing, permitting base interest rates to rise, and curbing inflation. As for infrastructure, building infrastructure spurs growth when it is needed by market actors. A better investment environment and, crucially, less state involvement will finally draw the foreign investment the government keeps hoping for. This in turn will help ensure that infrastructure projects are commercially sensible, not political boondoggles.

American investment in India would create jobs not only for urban workers, but also eventually draw in rural underemployed and thus improve agricultural productivity. Legal and technical assistance, if India is willing, could sharpen rural property rights and transform agriculture and larger rural well-being.

In trade, India freely imports goods it cannot manufacture, such as crude oil, and often faces ensuing inflationary pressure. For items it can manufacture, it sets protectionist barriers of various kinds that raise the price of imports. This is also inflationary, of

30. “Abbott’s HIV Drug Patent Plea Rejected for Lack of Novelty,” *Business Standard*, January 4, 2011, at *http://www.business-standard.com/india/news/abbott%5Cs-hiv-drug-patent-plea-rejected-for-lacknovelty/420650* (August 2, 2011), and Ashby Jones, “India Sets High Bar for Patent Protection, But Is it Too High?” *The Wall Street Journal Blog*, February 12, 2010, at *http://blogs.wsj.com/law/2010/02/12/india-sets-high-bar-for-patent-protection-but-is-it-too-high* (August 2, 2011).

31. Amol Sharma, “India Solar Rules Burn U.S.,” *The Wall Street Journal*, February 8, 2011, at *http://online.wsj.com/article/SB10001424052748703507804576130060294951704.html* (August 2, 2011), and Sarita C. Singh, “Liability Clause Threatens Nuclear Power Programme,” *The Economic Times*, July 15, 2011, at *http://economictimes.indiatimes.com/news/economy/indicators/liability-clause-threatens-nuclear-power-programme/articleshow/9230394.cms* (August 2, 2011).

32. Shikha Dalmia, “India’s Faulty Exceptionalism,” *The Wall Street Journal*, April 2, 2009, at *http://online.wsj.com/article/SB123861220879979199.html* (August 2, 2011).

33. Adith Charlie, “Cognizant, HCL Under US Embassy Scanner,” *The Hindu Business Line*, June 13, 2011, at *http://www.samachar.com/Accenture-Cognizant-HCL-under-US-embassy-scanner-lgnwL7gbjbb.html* (August 2, 2011), and Manish Sabharwal, “Rationing Foreign Workers,” *Live Mint*, August 18, 2010, at *http://www.livemint.com/2010/08/18204809/Rationing-foreign-workers.html* (August 2, 2011).

course, as one of the biggest benefits of open trade is lower prices. A crucial example: India has perhaps the most pressing health needs on the globe. Medical imports could work wonders for tens of millions or more and the U.S. should be the premier source. Yet U.S. medical exports to India in 2010 amounted to just 50 cents per Indian citizen.[34]

Multilaterally, Indian re-embrace of the market would very likely yield, eventually, a WTO accord. While they were certainly not the only obstacle, Indian complaints in agriculture stalled the Doha round at its closest point to fruition. Reform would reduce pressure on Indian agriculture and expand Delhi's range of options.[35] The clincher is that an actively reforming India could make many offers to compensate its partners even should it decide to retain some barriers. A reforming India would also boost the attractiveness of liberalizing global trade, increasing others' incentives to sign on.

A willingness to open further to investment and imports would also dramatically change the APEC view of Indian participation. At APEC, a liberalizing, consumer-driven India would be a valuable friend to the U.S. and a facilitator of freer global trade, not a hindrance to it. Likewise, in ASEAN forums, India as a new friend of liberalization and globalization would help ASEAN refine its vision of an integrated, liberal, and outwardly oriented market.

Two Different Paths

The U.S. should, to the extent possible, encourage India to return to market-led development. One way is to resolve the current American political standoff over GSP in a way that maintains India's place in GSP—if it becomes a better partner for the U.S.

However, American policy must respect democratic India's internal decisions. If India does not choose market reform, the potential for the economic partnership is quite limited. Then the U.S. should capitalize on comparative advantage to the extent possible now. The leading area of American comparative advantage is intellectual property. The leading area of Indian comparative advantage is labor in low-margin services.

1. **The U.S should ask for improvements in treatment of American intellectual property.** In return, it should negotiate better access for Indian workers to the American labor market.[36]
2. **Absent countrywide reform, American economic diplomacy should shift from the Indian national government toward engaging the individual states pursuing market reform.**
3. **The U.S. should evaluate whether countries whose income level has grown too high for GSP treatment might retain their status if they qualify as market economies.**

   If India does return to the market, there will be many opportunities to greatly advance the bilateral economic relationship.
4. **The Indian government should move away from state-led infrastructure spending as its development strategy** and restart market reforms like those it implemented 20 years ago.
5. **If reform restarts in substantial fashion, the U.S. should make an offer in BIT negotiations that addresses Indian concerns** about protection of workers and firms involved in investment in the U.S. The timing of increased market access to India can follow and reinforce India's own reform schedule.
6. **If reform restarts in substantial fashion, the U.S. should offer to begin negotiations on a free trade agreement.** A renewed India commitment to the market would make any eventual agreement far superior to the ones India has signed to date.
7. **If reform restarts in substantial fashion, the U.S. should push for full Indian membership in APEC.**

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34. Geeta Anand, "India's Public Health Crisis: The Government Responds," *The Wall Street Journal*, July 30, 2011, at *http://blogs.wsj.com/indiarealtime/2011/07/30/indias-public-health-crisis-the-government-responds/* (August 2, 2011), and U.S. Census Bureau, International Trade Statistics.
35. International Year of Rice 2004, "India," 2004, at *http://www.fao.org/rice2004/en/p6.htm* (August 2, 2011).
36. S. Saroj Kumar, "U.S. Unhappy with Indian Social Security Model," *The Financial Express*, July 28, 2011, at *http://www.financialexpress.com/story.php?id=823240* (August 2, 2011).

8. **If reform restarts in substantial fashion, the U.S. should bring a new proposal to the WTO**, taking specific advantage of the changes in the Indian view of liberalization.

Conclusion: In Indian hands

The U.S.–India economic relationship is much weaker than it could be. The two economies are complementary, but India's move toward the state and away from the market constitutes an insuperable barrier to more extensive ties. American policy is hamstrung.

To address its current economic problems, India should reduce state intervention and return to market-led development. If this happens, there is a broad range of steps the U.S. should take to help make the bilateral economic relationship, ultimately, the world's most important. If India remains wedded to state-led development, however, bilateral economic cooperation will remain subdued.

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