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INNOVATIVE INDIA AND THE UNITED STATES

INDIA: A Glass half empty or half full?

By
Dr. Walter Andersen
SAIS, Johns Hopkins University

There is a renowned recent German film that looks at the life of an elderly woman in East Berlin who went into a coma shortly before the unification of the two parts of Germany in the early 1990s – and gained consciousness well after the dramatic changes that had begun to transform the east. If someone in India had a similar experience during this same time frame, the changes that person would find in India would be equally dramatic as those in East Germany – and just as disconcerting.

Beginning in the last decade of the 20th century, India has moved away from the inward-looking and inefficient socialist pattern of development set in place at the time of its independence in 1947. In the early 1990s, a new reformist Indian government began to dismantle much of the state controls with a set of far reaching market reforms that unleashed the latent entrepreneurial talents of Indians. The late Senator Daniel Patrick Moynihan, who had served as U.S. ambassador to India in the early 1970s, remarked that Indians do superbly well in business everywhere except in India – and a major reason for this, he correctly argued, was the stifling control over all business activity by the bureaucracy.

Moynihan might well have had the Indian American community in the United States in mind when he made this assessment. According to the most recent U.S. census estimates, Indian-Americans are the wealthiest ethnic group in the United States; they are also at the top in the proportion of its working population who are entrepreneurs and the community also has the highest proportion boasting advanced education degrees – and whose children are in college. Moynihan's proposition about the prospects of business in India would not apply now. In fact, Indian business houses – in pharmaceuticals, steel and information technology to name only three – are aggressively either setting up or buying up subsidiaries all over the world. The latent entrepreneurial talent of Indians has been unfettered.

There is currently a debate over whether the surge of entrepreneurial activity in India and the unprecedented rate of growth of the country's economy over the past decade will continue. Sometimes, that debate is put in the context of a comparison with the other dynamic Asian economy – China. The skeptics I will label the supporters of the "glass half empty" school. The other view, which I identify with, subscribe to the "glass half full" argument.

Glass "half empty." India's problems are very real and sometimes daunting. They are problems that challenge India's continued development unless addressed. There is enormous corruption among a still powerful bureaucracy that can make life difficult for investors, both Indian and foreign. In addition, the road, rail, and power infrastructure are in poor shape in large parts of the country and investment levels in these areas are still insufficient to sustain for too long economic growth at the current annual rate between eight and ten percent.

As a consequence, transportation costs are expensive – almost twice that of China for example; power frequently fails, requiring manufacturers to install expensive generators; and the wait time to load cargo on to ships works against the international competitiveness of Indian products. In addition, poverty remains very high and enormous slums proliferate in all the major cities as the poor seeking employment opportunities flock to large urban centers.

In mid-2004, democratic India had another set of national elections, and a coalition government was formed that was dependent on the two communist parties, adding to the case for the "half empty crowd." A large part of the population in those elections rejected the slogan of the then-coalition government, which talked of India "shining" with an economic GDP growth rate in 2003-4 between eight and ten percent. The country experienced an unprecedented spurt in housing starts, a booming stock market, and a rapidly expanding international trade.

For hundreds of millions of people, the glitter of the new India had not reached them and the national elections were a wake-up call to politicians that they had to address the needs of the poor, especially the rural poor. Yet, even the government elected in 2004 has not dismantled the reforms implemented since the mid-1990s. Too many people have benefited from these reforms and India as a country has strengthened its position on the world stage because of them.

The initial fears of the local and international business community that the newly elected national government, which was dependent on the support of the communists would not expand the range of reforms has proved wrong. There are clear signs that private investment is picking up. For example, my wife, an Indian business women, is one of those demonstrating her faith in the new India by constructing a new state-of-the-art manufacturing unit in an industrial suburb of Delhi that will triple her productive capacity to enable her company to compete more effectively in the brave new world that emerged at midnight December 31, 2004 when the WTO multi-fiber agreement came to an end and world trade in cloth and apparel was stripped of various restrictive quotas.

"Glass half full." It is first important to understand the three realities that the Indian leadership had to confront in 1947 as the British colony became an independent country.

(1) This was an India whose average annual economic growth rate from the turn of the 20th century until 1947 was about one percent, below population growth in most years and far too low to make any real dent on the huge numbers of people living in a destitute situation and depriving them of any real hope that the future would be better. Part of their pessimism was fueled by periodic famines, one of the worst occurring during WWII when millions of poor people in northeast India starved to death. The political class of independent India was determined that the enormous poverty it inherited must be at the top of the policy agenda and only the government had the resources and national perspective to address it.

(2) India was in 1947 as well as today is one of the most socially diverse countries in the world. Fears remain that ethnic and religious tensions will tear the country apart and repeat the partition of British India in 1947 when the Muslim majority provinces of British India were separated from the country. Indians speak dozens of languages and some are as different from each other as French is from Japanese. Linguistic differences are so major that India's political elites found it prudent to adopt a foreign language as one of its two national languages: English continues to share that honor with the indigenous Hindi language. It is also religiously complex. While some 80 percent of its 1.1 billion people are Hindu, there are huge numbers belonging to other faiths. There are 140 million Muslims, giving India one of the world's largest Muslims populations. There are millions of Buddhists and Christians with Christianity represented substantially in its three expressions of eastern orthodoxy, Roman Catholicism and Protestantism. Even the Hindu majority is deeply divided by social and sectarian differences. The political elites in this circumstance opted for secularism.

(3) India emerged onto a world sliding into a Cold War which the country's founding fathers feared could bring the great powers back to South Asia in ways that would undermine its hard won independence. They were determined to stay outside entangling foreign alliances, a stance very similar to the founding fathers of the United States as they sought to keep European rivalries from being fought out in the Americas.

India's founding fathers fashioned a set of three broad domestic and international policies to address the daunting realities faced by the new country. They were optimistic that these policies would produce economic equity, political integration, and preserve national independence.

(1) On the strategic level, India adopted a policy of nonalignment meant to keep the great powers out of South Asia, a policy difficult to achieve because it was opposed by next door Pakistan, which sought alliances with outside powers to use as a force multiplier against a much larger and wealthier India. The Cold War provided an opportunity for Pakistan in the early 1950s to join the efforts of the West to contain Communism. Pakistan ostensibly joined two treaty arrangements with the West in the 1950s (CENTO and SEATO) to contain communism, though Pakistan's objective was really

to contain India and to gain international support for the disputed state of Jammu and Kashmir (REFER TO MAP), India's only Muslim majority state. As a consequence in the Cold War, India and the United States often found themselves in a tense relationship as Indians viewed the close relationship with Pakistan as a threat to Indian security interests.

(2) On the economic front, the founders adopted a program of Fabian socialism and state-directed industrial and infrastructure growth that many hoped would result in both equity and rapid economic growth, at least rapid enough to lower the alarmingly high rates of poverty. They were convinced that only the state had the capital, the knowledge, and a concern for the general well being to achieve these goals. As a consequence they forged an elaborate system of controls that gave the state the ultimate power of decision-making over virtually every economic action. They also erected high tariff barriers and adopted a system of import substitution to protect the country's fledgling industry. They also made foreign investment difficult and gradually forced such companies as Coca Cola to sell out their Indian interests.

(3) On the political front, the founders adopted a democratic system based on the English Westminster parliamentary model; a system they believed would act to integrate the many different ethnic groups in this highly plural nation. The vote was made universal to give the people a stake in their future and to underscore the notion of political equality. The founding fathers moreover self-consciously avoided any religious favoritism, even though over 80 percent of the country is at least nominally Hindu. The creation of Pakistan as a homeland for the undivided India's Muslims was looked at as a warning sign of the dangerous consequences of religion in politics.

The optimism of a bright future for the country began to fade in the 1960s as economic growth rates settled into a range later described – somewhat sarcastically – by a prominent Indian economist as the "Hindu rate of growth," about 3.5 percent per year, slightly above the population growth rate and too low to make a substantial dent on the continuing high rates of poverty.

It became increasingly clear that the heavy involvement of the state in virtually all economic decisions was not producing the anticipated benefits. Few public enterprises earned profits, forcing the state to use scarce resources to keep them afloat. They typically employed too many people and were run by risk-averse bureaucrats who often knew very little about the industry they were managing. In addition, the pervasive licensing system suppressed entrepreneurial talent at every level and at every place. The licensing system, in addition, was a lucrative source of corruption for bureaucrats and politicians, a major reason it was so hard to change, even after virtually every economist in India argued that it had to be reformed, if not abolished.

The modest rate of economic growth also had political consequences that seriously undermined social and political stability – and the reason for this was the disjuncture between stagnant economic growth and exploding political demands by historically disadvantaged groups. The democratic system was the one thing the founders had done that worked the way they had expected: it had empowered hundreds of millions of the formerly disadvantaged, and they demanded a better quality of life. On the average, some two-thirds of Indians vote in elections, far higher than the average in the U.S. It is also somewhat unique among stable democracies in that a higher percentage of the poor vote than the rich.

But low rates of economic growth forced politicians into a dangerous zero-sum dilemma. If they acceded to the demands of the newly politicized poor, the "haves" would experience a reduced quality of life, a politically dangerous situation. If nothing were done for the poor, an equally dangerous situation emerges. This situation was a cause of mounting violence in the late 1970s and 1980s and came to a head in the 1990-91 when it became clear that fundamental changes had to be made.

In two ways, India's political system did correct itself in the early 1990s. One was political and the other economic – and in ways that substantially improved the stagnant economic growth rates—and altered Indian foreign policy.

First, on the economic side, the majority party in parliament, following the 1991 general elections, selected an intellectually brilliant prime minister and a shrewd politician. He had a vision of reform with goal of speeding up the economic growth rates and he who was a shrewd politician who knew how to get around the major obstacles from politicians and bureaucrats who would resist changes that would undermine their parasitical hold on the economy.

His finance minister, Manmohan Singh, the present prime minister, ably assisted him. Manmohan Singh's chief bureaucratic assistant was Montek Ahluwalia, now the prime minister's chief economic adviser. The present finance minister is P. Chidambaram, who was the finance minister after Manmohan Singh. Under the guidance of the Prime Minister, they were a brilliant trio. What they did was breath-taking and effective:

(a) Abolished the pervasive licensing system, thus unleashing the talents of Indian entrepreneurs as never before.
(b) Began to whittle away at tariffs, among the highest in the world, which forced Indian industry to improve its quality control.
(c) Reduced the value of the rupee, starting at 8 to the dollar and now hovering around 45 to the dollar, to improve the competitiveness of Indian exports.
(d) Permitted private investment in most areas of the economy, and
(e) Opened the country to foreign direct investment, though with limits in some areas (like insurance) on how much of an industry foreigners could control.
(f) Reoriented foreign policy to focus on countries that could help them economically – and thus the U.S. became the focus of Indian foreign policy attention, a linkage that was to have strategic consequences when the U.S. began to look at a strong, stable and democratic India as a potential strategic partner in an Asia wracked by tensions. If you look at that broad stretch of the Indian Ocean littoral from west Africa to Indonesia, (an area my colleague Zbigniew Brzezinski referred to when he was in Carter Administration as an "arc of crisis") India stands out as an area of stability in an area that is still in crisis.

There were three big things the new Indian reformers did not do because of constraints imposed by the country's democratic system. (1) They did not move vigorously to privatize public enterprises and they are, like in China, a drag on the economy; (2) they did not reform labor laws that make if virtually impossible to fire workers; (3) they did no reduce the massive subsidies that are a major reason for high fiscal deficits. They did not move on the first two issues because millions of people would lose their jobs, a politically unacceptable situation in a country that lacks a system of safety nets. There has been some tinkering around the edges, but no Indian government, and certainly not the one in power now, will take dramatic steps, even though both work as a disincentive to investment. What clever Indian entrepreneurs have done, at least on the labor issue, is either to use connections to get around the regulations – or to redefine what is labor in some creative way. On the third issue, subsidies, politically powerful interests resist any substantial reduction in allocations.

On the larger issue of economic reform, no major political party in India, not even the communists, want to discard the reforms. The question is on the pace and the scope of further reforms. A major reason for the general public support for the reforms so far is that they have produced positive results that affect the lives of tens of millions of people.

(a) Poverty has been reduced at a faster rate since the adoption of the reforms than at any period in India's independent history (and the current rate of reduction is an impressive one to two percent a year).

(b) The Indian economy has grown at a faster pace over the past decade than ever before – on an average over double the 3.5 percent "Hindu rate of growth", producing new jobs and opportunities, and one of the major causes for the sharp drop in poverty. Over the past few years, the economy has surged ahead at eight to ten percent. Often not recognized is that India's real GDP has grown faster than all the Asian "miracle" economies of East Asia – except China – since 1992.

(c) Trade has been on the rise dramatically since the introduction of market reforms in the mid- 1990s, after decades of an autarkic approach that witnessed a declining trade/GDP ratio. Trade has quadruped since the introduction of market reforms, with a total of over $255 billion in two ways trade anticipated in the 2006-2007 fiscal year. Growing at an especially fast pace are service exports, including information technology. Trade in services grew at an extraordinary pace from about $2.5 billion in 2000 to over $17 billion in 2005 and the U.S. is the largest single market for Indian services. Trade journals suggest trade in services could grow to $50 billion in current dollars by 2010. Regarding the U.S., a kind of symbiotic relationship has grown between U.S. businesses and institutions and their Indian suppliers of BPO services. To give just one example: Johns Hopkins University Hospital, one of the best research hospitals in the world, has much of the analysis of its diagnostic work done in India. The university's payroll, by the way, is also done in India.

(d) The estimate destination of trade for 2006 – 2007 is revealing: The U.S. is still the single largest trading partner with some $27 billion of trade in 2005. China came second with $20 billion if you include Hong Kong. And trade with both bears two interesting similarities: both have been growing at about 30 percent per year for the past few years and India has a trade surplus with both, and with the U.S. it is substantial with a $7 billion trade advantage.

(e) India, which hovered on the brink of bankruptcy in the early 1990s, now has about $150 billion in foreign currency reserves and the figure continues to grow at a fast pace. Its stock market is one of the fastest growing markets in Asia and attracting substantial foreign inputs.

(f) India's banking system has become far more professional about its lending practices with laws that tighten criteria and give them the power to seize the assets of delinquent borrowers. The result is that the non producing loans as a percent of the state run banking assets has declined from 5.3 percent in March 2001 to 3.5 percent in March 2004; the decline in private banks over the same period was from 2.3 percent to 1.3 percent. (By way of comparison, one source I have seen notes that about one half the Chinese loans are non-producing.)

The second new development is the political changes that have occurred since the 1990s. Starting about that time, Indian politics, after years of domination by one party, became truly competitive as the long dominant Congress Party, ruling the country almost continuously from independence in 1947 until 1999, lost its competitive edge. It had grown corrupt, often unresponsive to demands, and intellectually flabby. Starting in 1991, no Indian government has won a majority of the parliamentary seats. Starting in 1996, every government has been a coalition. Indians hold their politicians responsible for their performance; in sharp contrast to the U.S., a majority of Indian incumbents at both the federal and state level do not win their reelection bids.

The major gainers in Indian politics over the past 15 years have been regional parties and for the first time in the 2004 national elections, they collectively actually outpolled the two national parties: the slightly left of center Congress; and the slightly right of center Bharatiya Janata Party –usually referred to by its acronym, the BJP.

The success of regional parties means several important things:

(1) First, those Indian governments at the center will remain coalitions for some time to come. The winner will almost certainly be the national party that is able to work out a good coalition arrangement. In the last elections, the incumbent National Democratic Alliance led by the BJP, for example, did not do as well as the Congress Party led-United Progressive Alliance (UPA) in putting together a viable coalition. In fact the two coalitions received almost exactly the same percentage of popular vote. Subsequent local state elections have indicated that the Indian voter continues to divide the vote among a wide array of parties. It is the prospect of losing to the BJP and its allies in new national elections that is probably the great cement for the present coalition government. For that reason, the UPA coalition led by Manmohan Singh is likely to last its full five year term.

(2) The second consequence of the simultaneous rise of regional parties and coalition governments at the center has been the devolution of power in India's federal system of government. From independence until the early 1990s, the trend had been toward centralization

for reasons of security and centralized planning. But with the advent of coalition governments, there has been a course reversal and states have a growing voice on how they will spend their tax money and on issues of investment.

Coalition politics, in my view, has worked to India's long-term benefit. It enforces accountability; it opens political power to newly politicized groups and thus strengthens political legitimacy, and it encourages the decentralization of power to better reflect the diverse social complexity of the country.

Coalition politics also reinforces the ideologically centrist tendency of Indian politics. There is a broad consensus on fundamental issues, like market reforms, worked out among the many layers of this very socially complex country. The change of governments usually does not bring major changes. This was witnessed with the most recent change. Though the UPA is slightly left of center and a bit more conscious of the needs of the poor, it has not altered the policies of the NDA government in any significant detail. India thus moves at a measured pace on any change, like the market reforms. This may drive ideologues, economists and good government types to distraction, but it also insures a large measure of political stability, consensus and political legitimacy. This is not a country likely to experience revolutionary activity. That alone makes me part of the "half full" crowd.

Not to sound excessively optimistic, there remain on some big problems that must be addressed if the present robust rates of economic growth are to continue.

(1) **Infrastructure.** India, which is spending only some six to seven percent of its GDP on infrastructure in 2005 (about $40 billion), and this is far short of requirements of a rapidly expanding economy (China by way of contrast spends over twice that amount in infrastructure). Private enterprise has not moved into this area as expected when reforms were introduced, in part because of political interference and, at least in the case of electrical power, there is a lack of profitability, with prices kept artificially low and illegal pilferage high (only a few years ago power pilferage was almost 50 percent in Delhi before the privatization of electrical distribution there). India's economist prime minister, clearly aware of the shortfall, has announced plans to expand the amount spent on infrastructure amount by some ten percent, a figure still far short of needs.

    The huge highway building program, in some ways modeled after the U.S. both in terms of concept and financing, begun in the last years of the previous administration is an example of the political sill and creativity that needs to be applied to electrical generation, rails and harbors. It is funded by a tax on gasoline – on the people who use the highways – and has been able to raise billions of dollars for a program well on the way of linking the country together with a modern system of highways.

(2) **Health and education.** On education, India's literacy rate did move from 24 percent at independence to about 66 percent at the time of the 2001 census, but this is still short of what is required for continued rapid development. The problem is most severe at the lower elementary school level. Education is a state subject in India's federal system

> and some states, most notably in South India, have a rather good record while those in the Hindi-speaking center of the country, home to some 40 percent of the population, have a dismal record. This has an impact on prospects for economic growth, with advantage on investment to places able to provide trained labor. With the increasing decentralization of political power mentioned above, the result adds to the growing disparity between the economic achievements in different parts of the country.

There is a general silver lining on the education issue, however. India's economy benefits from the post independence policy of investing heavily in higher education, especially in technology and the sciences – and largely in the English language, which gives India comparative international advantages in the booming knowledge economy. Some 250,000 English-knowing students graduate each year in engineering and the hard sciences, putting India near the top in such trained personnel. Recent reports indicate that the number of technology/science graduates seeking jobs outside the country has declined by some 50 percent over the past decade, a reflection of their improved employment prospects in the country.

Educational achievement has enabled India to achieve the economic successes of the past decade. India has one of the world's largest pools of scientists, engineers and technicians. Current figures on university enrollments in these areas demonstrate that it is likely to remain one of the world's centers of scientific talent for some time to come. Almost two million university students, according to official reports, are currently enrolled in the hard sciences and math; another 500,000 are enrolled in engineering colleges. This does not count the 11 million students enrolled in institutions not affiliated with a university, somewhat the equivalent of American junior colleges and vocational schools. The numbers enrolled in science, math, medicine and technology have increased by about five percent a year for the past several years.

This large pool of scientific expertise has made it possible for India to play an increasingly important international role in research-intensive business, such as information technology, biotechnology and pharmaceuticals. Of these three, information technology is the largest and most developed. It employs more than 800,000 professionals, of whom about one-third are involved in Business Processing Operations. That number going into BPO areas is set to grow significantly over the next few years and that is possible because of the large and growing numbers of people graduating each year in the sciences and engineering.

Two related Indian knowledge-based industries – biotechnology and pharmaceuticals – have emerged as major global players in the past five years. Indian biotechnology companies in 2004 had crossed the billion dollars mark in exports and they grew by another 40 percent in 2005. Pharmaceutical companies had about 4 billion in exports in 2004 and that grew by about 25 percent in 2005. Six Indian companies dominate the market and all have substantial export markets. These companies are already the world's second largest course of vaccines.

The major problems facing Indian higher education in the sciences stem from rapid over expansion, lack of innovation caused by excessive outside controls, efforts to quickly achieve equity goals by expanding quotas for the disadvantages and lack of a sufficient number of qualified teachers. Moreover, the limited resources available for vocational and technical schools means that their graduates are often not prepared to handle the increasingly complicated technical tasks they will facer. If these problems are not addressed, they will cause major constraints on a further expansion of the fastest areas of growth and export in the Indian economy.

(3) **High fiscal deficit.** This places constraints on investment possibilities. The government currently spends about 40 percent of its revenue receipts just to pay interest on its debt. Official estimates are that the deficit for the 2005/06 fiscal year is equivalent to 4.5% of GDP (or some $40 billion just this year). The government has taken a number of steps to improve tax collection and impose penalties on states that need to borrow from the center because of their continual deficits.

However, a continuing problem is the very large percentage of GDP that goes into various sorts of subsidies, estimated to be about 10 percent of GDP (or some $60 billion in this past year). A substantial part could be eliminated on economic grounds because much of it goes to groups that could afford to pay. I am thinking specifically of landowning farmers who get cheap or free electricity, fertilizer, seeds, irrigation and so forth. But these groups have political power and will resist efforts to reduce these subsidies.

A good example of this is what happened following state elections two years ago in the southern state of Andhra Pradesh, whose incumbent government had a rather good record of reducing subsidies to free up money for investment. The winning candidate, campaigning on a populist platform, promised virtually free electricity to the state's farmers. His victory underscores the problems faced by India's economic planners. One prominent English political economist specializing on India has argued that subsidy reduction will take considerable stealth by politicians because the politically articulate public is likely to be resistant to change—and fortunately for India there are such people in both the federal and state governments.

The bottom line is that economic reform now has deep roots because it benefits huge numbers of people and enables the country to largely get around the zero-sum trap that seemed in the early 1990s to be the country's long term problem. Change will likely come at a more measured pace than in, say China, but it will likely be more long lasting because of a consensus among the major stakeholders.

Thus, if our fictional lady that I mentioned at the beginning were to go into another coma and wake up five years from now, she would likely find a country much on the same trajectory it is on now. And part of that trajectory is closer relations with the United States. Perhaps the most dramatic example of that has been the Bush Administration's proposal, now making its way through the Congress, to make India an exception to our nonproliferation laws that say that any country that has not signed the nuclear nonproliferation treaty of 1970 cannot receive civil nuclear assistance. Of course, India which declared itself a nuclear weapons power in 1998, is not a signatory to the treaty and has no intention of signing on to it. The Bush administration correctly argued that it had to get around this issue to develop the strategic relationship it sought with Asia's newest rising power.