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ISSUE BRIEF

# US-India Economic Integration:

## Towards an Agenda for Growing Manufacturing and Resilient Supply Chains

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### Introduction

China's rise and COVID-19 have injected greater urgency into how the United States and India work together to attract global manufacturing and ensure greater supply-chain resiliency. Both countries increasingly view China as a source of unfair trade competition—a multidimensional competitor that poses a security threat best managed by finding supply alternatives and achieving a degree of separation on key future technologies. COVID-19, China's assertiveness, and now Russia's invasion of Ukraine have underscored the need for diversified supply chains. Across industries, unanticipated supply shortfalls add to inflationary pressures and point to the value of greater bilateral coordination.

On strategic issues, China's overreaching has drawn the United States and India closer even when their foreign policy views and national interests are not fully aligned. Both could benefit from greater cooperation in manufacturing and supply chains as a response to China's state-backed economic machine. Despite the strategic benefits, however, the China factor sometimes acts as an obstacle to US-India economic integration; when they erect barriers at or beyond the border with "unfair" Chinese imports in mind, the governments often wind up hitting each other.

To date, US-India trade and investment flows have grown impressively, but official policies may limit the progress. The United States and India are both seeking to boost domestic manufacturing to create good jobs, while often turning away from new trade-liberalization initiatives. In India, successive budgets have spawned skyrocketing tariffs, nontariff barriers have also multiplied, and New Delhi walked away from the Regional Comprehensive Economic Partnership (RCEP). Domestic constituencies for open trade

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can be difficult to find. Meanwhile, in the United States, bipartisan political support for liberalizing goods trade has dissipated. Any new trade agreements are likely to reflect narrowed ambitions—limited agreements that do not require congressional approval. In short, manufacturing and supply-chain coordination faces some stiff headwinds.

Nevertheless, in 2021, there were signs that international manufacturers were taking a fresh look at India, as part of supply-chain diversification from China and in response to the Indian government's dedicated efforts. At the end of the year, US and Indian leaders talked about a new beginning. Can India and the United States take advantage of this unique moment to achieve greater economic connectivity? The question has taken on greater salience in the wake of RCEP having taken effect with Japan, Australia, and thirteen other participating countries in the Asia-Pacific.

## US-India Cooperation and Contestation

The United States and China have been locked in intensifying security competition dating back to the final years of the Barack Obama administration. For India, tensions sharply escalated with China in 2020 at multiple points along their 2,100-mile-long, contested border in the high Himalayas. The neighbors are talking, but remain mired in a persistent stalemate.

The resulting rethink within the Indian government, in particular, has led to modest, but positive, spillover into "dual-use" and purely commercial cooperation. A primary vehicle for coordination has been the Quad. On September 24, 2021, President Joe Biden hosted the leaders of Australia, India, and Japan for the first in-person Quad Leaders' Summit. They met virtually again on March 3, 2022. Last fall, the leaders confirmed a bold pledge to help vaccinate the world, established a closer infrastructure partnership, agreed to form a green-shipping network, and committed to work together on open, reliable, and accessible technology ecosystems. In 2022, work will commence on launching a semiconductor supply-chain initiative. The top level of India's government is keen to attract related domestic production.

Progress in these areas is important for both countries, but it isn't enough. These workstreams were not designed to cover important segments of both present-day economies, especially India's, and may not improve the welfare of at-risk workers. Over the long term, nascent Quad efforts to build a network of scientists, technologists, and engineers point to part of the answer. But, right now, the United States and India both need to find ways to secure more domestic manufacturing to create blue-collar jobs and help surrounding communities.

India has made remarkable improvements in the ease of doing business, but the cost of doing business remains high. The lack of local infrastructure is a crucial constraint on manufacturing. The 2022 budget focused on infrastructure spending to lay the foundation for growth, but that will take time. In fits and starts, the Indian government has tried to address structural economic factors that increase the cost of manufacturing. Crucial, but politically difficult, labor-market reforms remain a work in progress, and—after an initial, aborted attempt—the government has not revisited land reform. The cost of key inputs, such as electricity, also needs to be lowered.

A yet-to-be launched regional initiative being discussed in Washington, the so-called Indo-Pacific Economic Framework, may touch on a few relevant issues. Details are emerging, but senior US officials have hinted that technology, resilient supply chains, decarbonization, infrastructure, and worker standards will be part of the mix. A digital-trade agreement could be a key element of that evolving framework, if there is enough administration support for its inclusion. At present, the United States and India appear to be moving further apart, not closer together, on regulating cross-border data flows. This emerging gap raises natural questions about India's role in any multilateral agreement on digital trade.

### Digital Policies

The world's two leading digital democracies, the United States and India, should use shared interests and common strategic imperatives to propel an emerging digital order in the Indo-Pacific region. The challenge facing them is to go beyond vital cooperation on critical and emerging technologies to reach a separate, broader understanding on digital trade and data governance.

India is increasingly adopting data-localization measures due to national security and economic considerations. The much-awaited December 2021 Joint Parliamentary Committee (JPC) Report on India's Personal Data Protection Bill highlights the need for Indian "data sovereignty," and recommends an additional layer of nontariff barriers in the form of testing and certification of all hardware (including Internet of Things devices) by the proposed data-protection authority. Washington, on the other hand, has not been able to establish a comprehensive set of rules on regulating data, opting for a piecemeal approach through various executive orders, while states like California have their own laws. That situation is not lost on New Delhi.

India (and other countries) view the Mutual Legal Assistance Treaty process used to gather information in criminal law enforcement as slow and outdated. India's national security establishment is thought to believe that if data are stored within the country's borders, they will be easier to access. India has also increased budgetary allocations to build data centers. Data, of course, are essential for modern manufacturing.

While there has been a lot of attention paid to the implications for the high-tech and e-commerce sectors, India's evolving data-protection regime may create significant challenges for manufacturing collaboration as well. Firms use electronic information to track the performance of goods ranging from elevators to jet engines, increase productivity, and drive down costs, while also helping companies integrate with global supply chains by sourcing inputs and identifying new markets. So, further data localization will undercut efforts to boost US companies' investments in India's manufacturing sector.

### Other Trade, Investment, and Regulatory Policies

Bilateral trade differences go well beyond data regulation, and reflect divergent national economic circumstances, histories, governance models, and perspectives on who actually makes cross-border trade rules. At the World Trade Organization (WTO), India and the United States generally find even less common ground. Yet, top US and Indian trade leaders were able to reach agreement on a few market-access measures in a surprisingly substantive joint statement at the India-US Trade Policy Forum (TPF), convened last November for the first time since 2017.

Of course, it will take more than hopeful signs and the growing US-India friendship to achieve meaningful outcomes that open markets to goods manufacturing, connect supply chains, benefit workers, advance lagging female workforce participation, and green the environment. Success could well prove elusive given that, in both countries, politics increasingly trump economics on trade.

On a bipartisan basis, the United States has been tilting toward a more closed approach to trade. Since President Donald Trump famously ran on an anti-trade, anti-immigrant platform and withdrew the United States from the Trans-Pacific Partnership, there appears to be a broadening domestic political alignment against negotiating free-trade agreements. US policy has turned to helping Americans left behind by globalization, and onshoring manufacturing to protect national and economic security. This more inward focus, with China front and center, is understandable to a point, but it comes with opportunity costs for economic integration, the international competitiveness of domestic producers, and other regional partners.

In India, successive annual budgets have announced tariff hikes on a range of products; the most recent budget represented improvement in this area. Unique national standards, multiple and duplicative testing requirements, and localization rules constitute significant impediments to supply-chain integration. Adherence to globally accepted standards practices would allow companies in India to have an easier time exporting overseas. Various technical barriers to trade help explain why concerted efforts to encourage foreign companies to manufacture in India seem to have met with mixed results.

At the same time, the Indian government has consistently communicated a much greater openness to foreign direct investment (FDI). India's production-linked incentive (PLI) schemes are part of a global shift (including in the United States) toward industrial policymaking, picking different sectors that the government believes can be winners for the economy. So far, India has introduced these plans in at least fourteen areas, ranging from solar panels to textiles, with more under development. India intends to take advantage of companies' "China + 1" strategy to diversify supply chains and operations as a hedge against geopolitical uncertainty.

The government has taken steps to improve India's policy environment. Despite withdrawing from all bilateral investment treaties (BITs) and leaving out crucial investor protections in its model BIT, India has lifted FDI caps on equity investment and taken a series of steps to improve the ease of doing business. In 2019, the government reduced the corporate tax rate from 35 to 25 percent. Last August, the government announced it would repeal the retroactive taxation law, and settled tax disputes with Vodafone and Cairn Energy. It is sending renewed signals about privatizing government-run assets. In October 2021, the government sold India's iconic national airline, Air India, back to the Tata Group. Finally, in November, New Delhi decided to align with Organisation for Economic Co-operation and Development (OECD) global tax norms, reaching agreement on digital-services taxes.

On trade, India has made a visible push to negotiate new agreements. In February, India and the United Arab Emirates reached a Comprehensive Economic Partnership

Agreement to increase two-way trade and investment. India is in talks to negotiate new agreements with the United Kingdom, the European Union, and Australia—even reportedly broaching the possibility of a free-trade agreement with the United States last fall during Prime Minister Narendra Modi's visit. Skeptics ask whether any bilateral deals can be consummated and, if so, whether they will have enough ambition. But, at a time when highly industrialized economies in the West are struggling to keep markets open, even limited agreements would constitute steps toward unlocking export-led growth, and perhaps signal a positive directional change. India's own trade demands are typically modest and well known. They relate to the movement of services professionals, a Social Security Totalization agreement, and limited market-access requests.

Accelerated Indian policy reforms offer the prospect of reversing the shrinking size of India's manufacturing sector. Flagship initiatives like the PLI program could have an impact, but a roughly 5-percent reduction in the cost of manufacturing (in the form of subsidies), appears to be offset by duties on inputs of more than 6–7 percent of those costs. Tariffs and taxes on foreign companies continue to offer the short-term temptation of increasing government revenue despite their inflationary effects on the consumer and impact on growth, skilling, and technology transfers. And, when disputes arise, the slow pace of resolving them remains a key impediment to doing business in India—especially in manufacturing.

Finally, most of the manufacturing ecosystem in India is defined by rules established by state governments. The success of the national government's efforts to boost competition among them, and support their efforts where possible, will be critical to attracting manufacturing.

## Recommendations

The below recommendations are intended to be actionable. They account for the political and economic context facing both the US and Indian governments, as well as their recent, stated policy positions—while, at the same time, encouraging one or both countries to rethink the possibilities.

**Recommendation 1: Focus on robust implementation of the ambitious Quad Leaders' Summit agenda.**

The Quad set out to "advance practical cooperation on twenty-first century challenges" that included increasing production and access to safe and effective vaccines, promoting high-standard infrastructure, fighting climate change through development of cleaner fuel sources, partnering on emerging technologies and cybersecurity, and cultivating next-generation talent to accomplish these goals.

The agenda is bold and sweeping, but its authors might be running the risk of spreading themselves too thin. Implementation will test the countries' bureaucratic capacity and ability to coordinate effectively with each other, and with industry. It is also difficult to imagine significant, lasting progress unless trade officials in both countries can reach agreement on opening strategic supply chains, establishing common product standards and testing consistent with international norms, and reducing tariff and nontariff barriers.

The important work of the Quad and the State-Department-led, bilateral ICT Dialogue should continue on strategic matters such as building secure, reliable fifth-generation (5G) and sixth-generation (6G) networks, related telecommunications infrastructure, co-development of critical technologies, and cooperation on artificial intelligence (AI), quantum computing, machine learning, cybersecurity, and semiconductors. Enhanced intellectual-property enforcement will undergird progress in these areas. Tangible outcomes will boost manufacturing efforts in both countries.

**Recommendation 2: Work to reduce barriers in jointly identified areas such as health, digital services, and defense manufacturing.**

The United States and India have a history of collaboration in health, where members of the Indian-American diaspora appear to be well positioned to play a critical role. Specific outcomes in this area will be important to both countries' securing resilient supply chains.

Digital trade flows are critical to modern-day manufacturing; however, the partners appear to be growing distant on regulating data. Trade negotiators were not able to agree on creating a separate TPF working group to discuss this pivotal issue last year, but may now be more amenable to discussion. On an urgent basis, both countries need to renew efforts to find common ground on data localization, privacy, and competition. Related challenges inhibiting e-commerce should be addressed. Broader digital conversations should feature expert trade negotiators on both sides, supported by national security and foreign policy officials in their respective bureaucracies.

The sides should also explore new opportunities for deeper collaboration on defense manufacturing, auto and aircraft parts, agriculture tools and machinery, energy technology, and commercial space.

The movement of professional and skilled workers, students, and business travelers is critical to expanding and deepening the bilateral economic and technological relationship. The sides should engage on visa matters with early outcomes in mind, to ensure students, professionals, and communities of experts are permitted to make contributions to each country.

**Recommendation 3: Prioritize progress on the issues that trade negotiators have been discussing as part of an earlier, limited bilateral trade agreement.**

In 2020, negotiators made progress on a number of issues that were to be part of a "trade mini-deal" that, ultimately, was not signed. That work should be brought to completion. Areas that may be ripe for finding additional agreement are Indian price regulation of medical devices and greater access for certain agricultural exports. India wants the restoration of Generalized System of Preferences (GSP) benefits that were suspended in 2019. As an initial matter, reinstatement will require Congress to reauthorize duty-free treatment of US imports under the GSP program, which expired on January 1, 2021.

In return for GSP reinstatement, India may be willing to rationalize certain accumulating tariff and nontariff barriers. Such steps would enhance the competitiveness of Indian manufacturing and help India get closer to its goal of becoming a major global manufacturing and export hub.

**Recommendation 4: Commit to finding common ground on emerging, nontraditional issues.**

In both democracies, support for global economic integration and trade liberalization is tepid among political leaders. Important constituencies, such as everyday workers and citizens concerned about the environment, have traditionally been left out of the public conversation on trade. The Biden administration has centered labor, human rights, and the environment in its trade agenda. India's approach is markedly different, reflecting its status as a large, emerging market. But, it is important for both countries that these issues, and the recent TPF conversation on regulatory transparency and consistency, feature in bilateral discussions about global manufacturing and supply chains.

**Recommendation 5: Improve domestic programs to attract manufacturing, while being judicious about their use.**

Global investors appreciate India's more welcoming approach to foreign investment. But, once an investment has been made, businesses sometimes find it difficult to recoup the promised benefits. Consistent follow-through by national and state governments is important. New PLI programs contain local-content requirements that raise questions about WTO compatibility. The PLI initiative for large-scale electronics manufacturing was introduced to address the cost competitiveness of Indian electronics industries relative to other economic competitors. Higher tariffs on inputs and components reduce the impact of industrial policy and delay India's participation in global supply chains. Other Asian countries chose to adopt policies to boost labor-intensive exports. India may want to consider those examples, as focusing on technology and capital-intensive areas will not produce as many jobs.

The Indian government should specifically consider linking its current PLI program to its slow-developing National Industrial Manufacturing Zones (NIMZs) initiative. The latter program might benefit from being narrowed to fewer, sector-specific zones and, if possible, include government support for infrastructure, transport links, research and development (R&D), and workforce training. Such zones could better encourage investment in key sectors, and more readily tie output to global supply chains.

Finally, overuse of industrial policy, in either country, presents risks in terms of enforcement, transparent and uniform rulemaking, and substituting artificial supports for durable competitiveness.

**Recommendation 6: When aiming at China, be mindful of not hitting allies.**

Trade and investment barriers built with China in mind are having unintended consequences on domestic manufacturing. US and Indian businesses in India with operations in China import inputs or onshore investment from China. The current rules need to be reviewed to avoid disruption.

At the outset of the pandemic, the Indian government announced a new policy mandating that all companies that come from countries sharing a land border will need prior approval before being allowed to invest in India. The move appears to have been intended to prevent opportunistic Chinese takeovers of distressed Indian companies. However, the policy created confusion as to whether it applies to all companies from neighboring countries (including US companies with Chinese or Hong Kong operations), or a narrower subset, such as Chinese state-owned enterprises. According to some estimates, at least $6 billion in investment proposals have been delayed due to the lack of approvals from the government.

**Recommendation 7: Consider steps to enable local infrastructure development in India, such as the expansion of the US Treasury's municipal-bond program.**

India's most recent budget focused resources on infrastructure development critical to manufacturing growth. The country, like other emerging markets, has faced challenges in financing infrastructure. In 2017, the US Treasury Department helped Pune launch a municipal bond—the first in fifteen years. Building a deeper, liquid municipal-bond market requires time and expertise, but India's payoff could be sizable.

**Recommendation 8: Use the CEO Forum as a key tool to inform government-to-government (G2G) deliberations and outcomes related to the business climate.**

The US-India CEO Forum has played a significant role in bilateral commercial ties for the last seventeen years. A reconstituted forum consisting of new and prior members can drive an ambitious and inclusive commercial agenda. The forum is most effective when its activities and recommendations are tightly connected to official G2G dialogues and engagements, like the annual US-India Commercial Dialogue. In advance of these high-level meetings, the forum's working groups should engage regularly with government counterparts at the expert level to build closer public-private relationships and facilitate outcomes. The forum's final recommendations can be discussed by the chief executive officers (CEOs) with relevant cabinet officials in both countries, and reform-minded Indian chief ministers and US governors.

**Recommendation 9: Engage in knowledge exchanges on alternative dispute resolution and other ways to improve the efficiency of resolving commercial disagreements.**

Swifter dispute resolution would make it easier for manufacturing firms to conduct business in India. The Indian government has set aside funds to create alternative pathways to resolve commercial disagreements. Plans to digitize courts will improve efficiency. The United States and India should consider related technical discussions, and explore complementary areas of expertise.

## Conclusion

Toward the end of 2021, leaders in both countries showed early signs of an ambitious, shared vision for the future. Workers' and companies' welfare, domestic politics, China's rise, and a historic pandemic all point to the importance of the United States and India taking steps together on manufacturing and supply-chain issues. The strategic partners should emphasize early returns in 2022 to build confidence and momentum, consulting closely with industry, as well as labor and other stakeholders. The current window presents an opportunity to shift certain types of production to India, but it may not stay open for a long time. Adversaries and competitors are moving forward with their own plans for deeper integration. It is past time for the United States and India to prioritize a more robust economic relationship.

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