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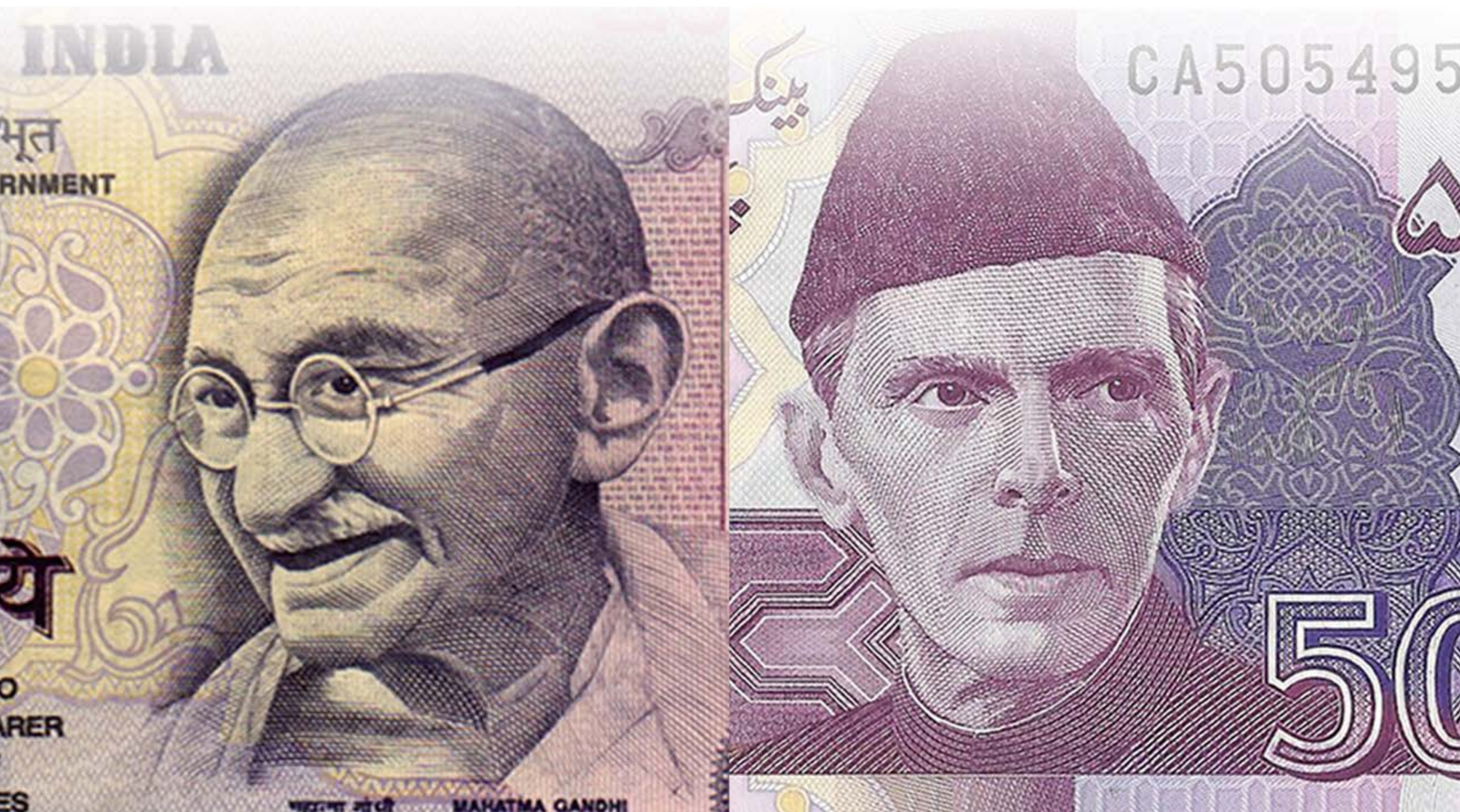
INDIA AND PAKISTAN
THE OPPORTUNITY COST OF CONFLICT



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India and Pakistan: The Opportunity Cost of Conflict

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FOREWORD

Mohan Guruswamy and Shuja Nawaz have produced an important paper on a topic of vital importance. They show carefully and convincingly how much the people of India and Pakistan have lost by way of income and security because of the hostility and military competition between them.

Of course, the cost of the military itself is substantial, particularly in countries where poverty is widespread and needs are acute. But the cost of arms and armies is only part of the problem.

Here we have two countries full of competent people and many complementary capabilities. In this setting, trade should be booming, much to the benefit of people in both countries. Instead, trade is at a mere trickle.

This situation contrasts sharply with other areas in the world, such as North America, where the vibrant trade among the United States, Canada, and Mexico raises the level of living in all three countries.

I hope this study will be widely distributed and that the facts and analyses it sets out will help bring greater stability to the India-Pakistan relationship. That would not only raise the income per capita of people in the region but it would also relieve the threat of a devastating nuclear exchange.

My compliments to the authors of this important study.

George P. Shultz

George P. Shultz

Distinguished Fellow, Hoover Institution, Stanford University

Former US Secretary of State

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EXECUTIVE SUMMARY

India and Pakistan, born out of a single British-ruled entity in 1947, have continued an implacable rivalry marked by periodic wars and hostilities as well as through proxies. This unending conflict has led them to invest heavily in their militaries and even to choose nuclear weaponry as a deterrence on the part of Pakistan toward India and on India's part toward both Pakistan and China. Although there have been occasional moves toward confidence building measures and most recently toward more open borders for trade, deep mistrust and suspicion mark this sibling rivalry. Their mutual fears have fuelled an arms race, even though increasingly civil society actors now appear to favor rapprochement and some sort of an entente. The question is whether these new trends will help diminish the military spending on both sides.

It is clear that increased spending has not brought foolproof security to either country. Indeed, their threats have changed much over the decades. Internal militancy and insurgencies continue to bedevil both states. The production of newer missiles, and tactical nuclear weapons adds further volatility and danger to this mix. Unless both sides can begin a dialogue on economic and military relations, they will continue to feed their defense budgets, increasing the opportunity costs of such expenditures. Such spending, even by an economically growing and more powerful India, will be at the expense of its massive segment of poor people, roughly a fifth of whom live at subsistence or below subsistence level. The foregone benefits in the economic and social sectors in Pakistan, which has a smaller economy overall and will likely be one-sixteenth the size of India's economy by 2030, are huge.

Both countries need to shift this trajectory of military spending and turn toward greater confidence building. They can do this by many means, including:

- increased people-to-people contacts and thus eliminate old stereotypes that fuel fears of each other;
- direct communications between their militaries, through exchange visits and more transparency about their military plans and movements;
- open borders for trade and tourism; and
- joint investments in energy, water, and export industries.

Recent statements, among others by Pakistani Prime Minister Nawaz Sharif at the United Nations, on the need to end the nuclear threat, portend some hope. But, given uncertain internal and regional developments, it is too early to see if there will be any major shift in spending on the military and on developing new weapon systems.

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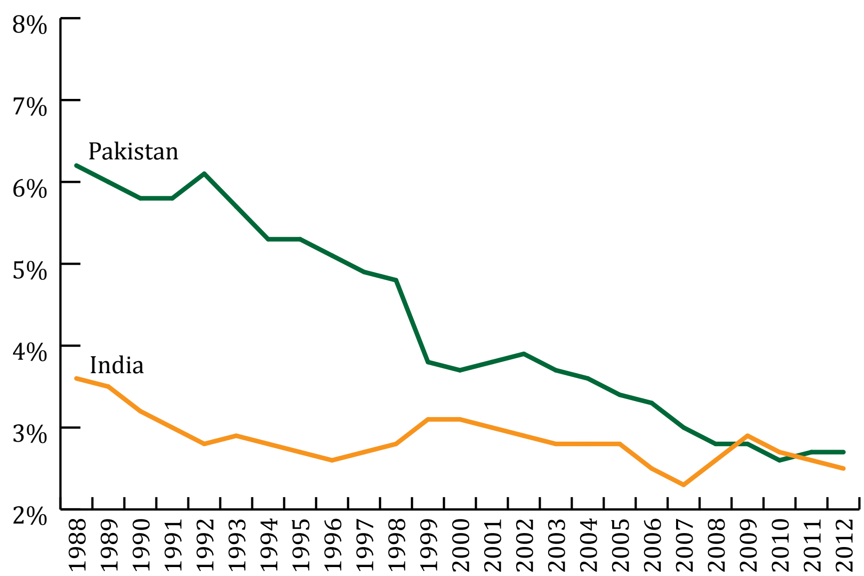
INTRODUCTION

In the space of sixty-six years since both countries became independent, India and Pakistan have fought three major wars and at least two limited battles that could easily have led to expanded war had there not been intervention by third parties leading to cease fires and negotiations. In the process of military competition, both have invested heavily in acquisition of new and more lethal weapon systems, including ominously the development of nuclear weapons. Yet, what the economist A.C. Pigou called "the shadow of war"[1] on peace continues to be a cause of concern, raising the question: what are both India and Pakistan foregoing in terms of economic development and social progress by continuing their military hostility and engaging in periodic conflict?

Today Pakistan has a population of 200 million and India 1.2 billion. According to the United Nations Development Program's human development indicators, 21.0 percent of Pakistan's population lives on under $1.25 a day. In India's case, while this has come down from 41.6 percent in 2005, but it has now become relatively obdurate at 22.6 percent. This coincides with a period when India's gross domestic product (GDP) grew at an average of over 7.4 percent, while Pakistan's economic condition deteriorated very clearly suggesting the need to maintain high levels of GDP growth to make a dent on poverty. Yet both countries' defense spending continued to rise in real terms, especially in the period 1998-2010, with India's defense expenditures growing in constant dollars from some $20 billion to over $45 billion and Pakistan's from slightly below $5 billion to slightly more than $5 billion over this period. The share of this spending in the GDP of both countries has declined over this period, with India's declining from under 5 percent to under 3 percent and Pakistan rising initially from below 3 percent to over 3 percent in 1999 and 2000 to below 3 percent in 2010.[2]

Defense spending continues to be multiples of the spending on health and education in Pakistan while in India its proportion has been falling gradually, and now is below both health and education expenditures. It is likely that as major segments of their populations become politically aware and active, especially as their youth, who form a substantial proportion of their huge populations (Pakistan's median age is twenty-two years, India's twenty-six years), become more globally connected and aware of their rights, concerns about health and education are likely to be the subject of much internal debate.

Military Spending as a Percentage of GDP



Source: Toby Dalton and Jaclyn Tandler, "Understanding the Arms 'Race' in South Asia," Carnegie Endowment for International Peace and SIPRI, September 13, 2012, http://carnegieendowment.org/2012/09/13/understanding-arms-race-in-south-asia/dtj0#.

1 A.C. Pigou, *The Political Economy of War* (New York: Macmillan, 1941), pp. 9-10.
2 Aguilar, Francisco, Randy Bell, Natalie Black, Sayce Falk, Sasha Rogers, and Aki J. Peritz, *An Introduction to Pakistan's Military.* (Cambridge, Mass.: Report for Belfer Center for Science and International Affairs, Harvard Kennedy School, July 2011).

SEEDS OF CONFLICT

India and Pakistan began their lives and independent states with a conflict in the territory of Kashmir. The Maharaja of Jammu and Kashmir vacillated on whether to accede to India or Pakistan, both of which claimed Kashmir as their own. To force the accession, elements in Pakistan's military headquarters fomented an incursion of tribal fighters into Kashmir. This was followed by the deployment of Pakistan Army regulars on October 22, 1947. When the Maharaja wanted India to intercede, India insisted upon a formal accession before it sent troops to defend against the "raiders" from Pakistan. Indian forces entered the fray on October 27, 1947, and to war between the two young states.

The strategic outlook for both countries has changed dramatically since they fought their first war over Kashmir in 1947-48. Kashmir remains a bone of contention but larger issues have begun dominating their defense thinking and planning. India now is a major regional and emerging global power in both economic and military terms. Its military forces of some 1.2 million persons now look beyond the threat of violence from across the Pakistani border, from both state and nonstate actors, to rivalry with China in the Himalayan border region and in new areas such as the South China Sea, the Straits of Malacca, and the greater Indian Ocean Region. India has long seen its responsibility as an Indian Ocean power with the ability to project force in the littoral states of the Indian Ocean and protect trade routes and offshore resources. Pakistan is no longer entirely India-centric, though for its military India still looms large in its calculations, perhaps unduly so. Pakistan faces a huge home grown threat of militancy and a hot border to the west with a volatile Afghanistan, where internal troubles beyond the departure of the coalition forces in 2014 could exacerbate Pakistan's fight against its own Taliban, by providing reverse sanctuary to Pakistani insurgents. India also sees Pakistan as China's military and political ally, and militarily prepares for a contingency involving both its rivals.

THE CHALLENGE FOR BOTH COUNTRIES WILL BE TO **BALANCE THE PROVISION OF SECURITY** FOR ITS POPULATIONS WITH THE NEED TO CREATE **ECONOMIC AND SOCIAL DEVELOPMENT AND GROWTH**.

Against this background, much debate and discussion is slowly bubbling to the top inside the military and civilian circles in both countries on how best India and Pakistan can alter their mutual calculus of conflict. Both countries are now nuclear powers and both are rapidly testing long and short-range missiles for delivery of conventional and nuclear payloads.

The challenge for both countries will be to balance the provision of security for its populations with the need to create the enabling environment for economic and social development and growth. Apportioning resources appropriately remains a huge task ahead at a time when devolution of political and economic power from the center to the periphery is occurring in both countries. The creation of regional political power centers in both India and Pakistan and the likelihood of weaker central governments over time creates additional hurdles to their ability to balance domestic needs against foreign relations and threats, real and perceived, from their neighbors. The choices they face between defense and development are not new.

GUNS VERSUS BUTTER

It was the Nobel Prize-winning economist, Paul Samuelson, who in 1948 first labeled productive and unproductive activities "butter" and "guns" respectively.

In coining the terms, Samuelson had the experience of Nazi Germany in mind, where the government was committed to increasing military expenditures (guns) at the expense of civilian production and consumption (butter). That is, the choice between butter and guns was a matter of economic policy. Not surprisingly the classical assumption of theoretical models of conflict implies the trade-off between productive activities (butter) and unproductive activities (guns). As guns increase, butter must decrease; there is no alternative allocation for available resources. The implicit assumption is that all productive activities are subject to appropriation.

Though the choice between guns and butter is now deeply embedded in popular consciousness, it is not as simple as is often made out. Countries that do not often or even ever fight wars prepare to fight them. Why does Singapore invest so much in its military? Or why should the countries in South America, which has had a rather enviable record in maintaining the peace, spend on their militaries? For that matter, why should countries like Britain or France or Germany, now witnessing the "end of history" in the sense that war is no longer in their horizons and even further from their minds, still maintain large militaries? The answer is quite simple. An adequate military keeps away war. Thus, some level of military spending is inevitable.

What makes things expensive for adversarial countries is the economic cost unrelenting inimicality imposes on them. One of the great-unanswered questions of our age will always be whether the USSR would have survived if it were not economically isolated from the West? China, which has a somewhat adversarial relationship with the United States, but nevertheless enjoys a close economic relationship with the United States, clearly prospers due to it. For that matter China has intensely adversarial relationships with all its other major economic partners like Japan, India, Taiwan, many of the Association of Southeast Asian Nations (ASEAN) countries like the Philippines and Vietnam, South Korea, and a somewhat uneasy relationship with its biggest neighbor, Russia.

Whynes cites an earlier study by Emile Benoit and Harold Lubell from the 1970s in which they tried calculating the opportunity cost of defense spending, using data for the developed countries.[3] They estimated that 28 percent of US expenditure was necessary for defense purposes and that this produced a net opportunity cost of 61 percent of the defense budget, or roughly 5 percent of the US gross national product (GNP). They did not examine developing countries in detail but India was examined "with the conclusion that the net opportunity costs ran around 2.5 per cent of GNP, or 55 per cent of the defence budget. The Third World en bloc, yielded a net cost of 37 percent of defence expenditures."[4] A fascinating footnote produced by the same study is that during the mid-1960s the developed countries' defense costs in aggregate represented over nine times their total allocation of international aid, perhaps adding to the opportunity cost of defense spending worldwide. Then-World Bank President Barber Conable estimated in 1989 that one-third of the debt of some major Third World countries could be attributed to arms imports.[5]

3 Emile Benoit, *Defense and Economic Growth in Developing Countries* (Lexington, MA: Lexington Books, 1973); Emile Benoit, "Economic Development and Cultural Change," vol. 26, no. 2, January 1978, pp. 271-280.

4 David K. Whynes, *The Economics of Third World Military Expenditure* (Austin: University of Texas Press, 1979), p. 76.

5 Shuja Nawaz contributed to the section of World Bank President Barber Conable's speech at the Annual Meetings of the World Bank in 1989 in which he raised an alarm about defense spending and made it a mandatory topic for discussion of aid programs with the World Bank. The International Monetary Fund followed suit. As Conable said, "Although there is much variation among developing countries, as a group low-income countries currently allocate around 20 percent of central government budgets to defense. In the mid-1980s military spending in developing countries exceeded spending on health and education combined. At a time when many components of national budgets have been cut, the $200 billion that the developing world spends annually on the military has largely been protected. And arms are often a prime source of external debt: military debt accounts for a third or more of total debt service in several large developing countries." Conable, "Address to the Board of Governors by Barber B. Conable," Washington, DC, September 30, 1989, http://documents.banquemondiale.org/curated/fr/1989/09/437469/address-board-governors-barber-b-conable.

SOUTH ASIA: A CONFLICT ZONE

The India-Pakistan story is an old one now. No two countries share the intense animosities as they do. Their post-partition engagement has not been very different than between the two great antagonists of the Cold War. They have fought five times and prosecuted unceasing campaigns to destabilize each other by somewhat unconventional means. This has certainly imposed costs on both of them. One does not have to labor too much over the fact that South Asia is the poorest region in the world with the greatest concentration of poverty in the world,[6] highest incidence of poverty,[7] and abysmal Human Development Indices.[8] South Asia also has the highest density of population in the world—342.25 persons per sq. kms.—and is the final and probably most formidable frontier in the battle against the great killers of mankind, like malaria and HIV-AIDS.

South Asia as a whole has experienced a long period of robust economic growth, averaging 6 percent a year over the past twenty years. This strong growth has translated into declining poverty and impressive improvements in human development. Still, the South Asia region is home to many of the developing world's poor. According to the World Bank's most recent estimates on poverty report "about 571 million people in the region survive on less than $1.25 a day, and they make up more than 44 percent of the developing world's poor…South Asia will play an important role in the global development story as it takes its place in the Asian Century. It has the world's largest working age population, a quarter of the world's middle-class consumers, the largest number of poor and undernourished in the world, and several fragile states of global geopolitical importance. With inclusive growth, South Asia has the potential to change the face of global poverty."[9] South Asia is nevertheless the second fastest growing region in the world and despite the early lead taken by the Southeast Asian countries, it has managed to hold its own in terms of growth rates without being significantly affected by the vicissitudes that visited the world economy.

6 South Asia is one of the fastest growing regions in the world. But millions still live in extreme poverty. It is estimated that more than a quarter of South Asia's 1.4 billion people cannot even attain their basic needs as defined in the context of the country they live in. The region is home to more than 375 million of the world's poor, which represents the largest concentration of poverty among all regions of the developing world.

7 Incidences of poverty in India and Pakistan are 29.8 percent and 22.3 percent, respectively.

8 India is ranked 136 and Pakistan 146 out of the 187 countries listed by United Nations Development Program's Human Development Index. In South Asia as a whole, nearly half of the children under five years remain malnourished. Universal primary education has not been achieved for most countries (the region exhibits the world's highest illiteracy rate among youth of age fifteen to twenty-four). Disparities between men and women in human development are pervasive.

9 World Bank, "South Asia Regional Brief," September 25, 2012, http://www.worldbank.org/en/news/feature/2012/09/25/south-Asia-Regional-Brief.

INDIA AND PAKISTAN HAVE FOUGHT **FIVE TIMES** AND PROSECUTED UNCEASING CAMPAIGNS TO DESTABILIZE EACH OTHER BY SOMEWHAT **UNCONVENTIONAL MEANS.**

WHAT IF?

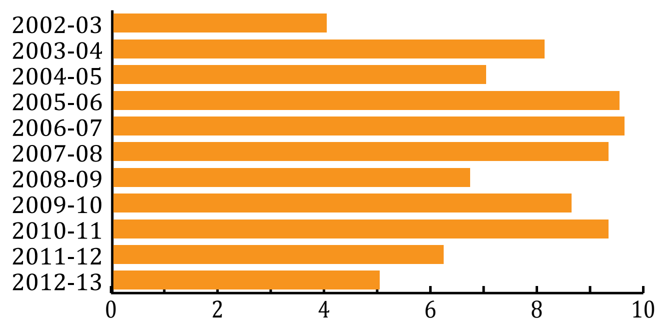
What if the region had not persisted in the relatively high defense expenditures since the 1950s? A leading Pakistani economist, Parvez Hasan, who held senior positions in Pakistan and then at the World Bank, did an exercise that is best described in his own words:

> “One is tempted to speculate on what might have happened if defence spending, which at its peaks in the late-1980s, reached 7 per cent of GDP, had been half the level [emphasis added], and that these resources had been allocated to social and economic development and potential economic gains from regional economic co-operation had been optimized. It is not frivolous to suggest that Pakistan’s economic growth rate over the long period of 1970-2010 could have been at least 2 percentage points higher than it actually was—that is, 6-6.5 per cent per annum, rather than 4-4.45 per cent per annum. This would have meant an economic size double of what we have, higher education levels, lower poverty incidence, and less social tensions, including less extremisms. It is also interesting to note that, with an economic size twice the present level, the actual defence spending, would not be any lower, even if the percentage of GDP allocated to it was half the present level. If one adds to the mix the assumption of greater trade and economic co-operation between India and Pakistan over the past four decades, one can argue that the whole history of the subcontinent could have been a happier one.”[10]

Another major Pakistani economist and former caretaker finance minister, Shahid Javed Burki, in his study on the Kashmir dispute for the United States Institute of Peace posits the following:

> “If Pakistan had spent 2.5 per cent of defense—a proportion roughly equivalent to that of India—it could have saved as much as 3 per cent of GDP per year. Compounded over the length of the conflict, the amount saved is equivalent to four times the country’s current GDP.”[11]

India’s GDP % Growth, 2002-2013



Source: “India GDP Growth Rate in last 10 years: 2003-2013,” *InvestorZclub* (blog), May 31, 2013, http://www.investorzclub.com/2013/05/india-gdp-growth-rate-in-last-10-years.html.

The result would have been a 50 percent increase in GDP over fifty years, according to Burki.

The financial muscle of Indian business is now making a global impact. It has one of the youngest population cohorts in the world and is poised for a dramatic economic growth. In last ten years India’s GDP grew at a compounded annual growth rate of around 7 percent with growth rate as high as 9.5 percent in fiscal year (FY) 2006 and 9.3 percent in more recent year 2011 to as low as 4 percent in 2003 to 5 percent in the latest year 2013.[12]

Yet South Asia is not economically integrated in any meaningful sense. India is its undoubted economic and military leader but has few linkages with its neighbors. Elsewhere in the world regions have grown dramatically because of their economic integration. ASEAN and Japan have been the biggest drivers in the stunning growth of China. The irony is despite their relative lack of engagement, the South Asian countries have been posting impressive growths. Greater integration would only speed this process and also pave ways for better understanding.

10 Parvez Hasan, *My Life, My Country: Memoirs of a Pakistani Economist*, (Lahore: Ferozsons, 2011), p. 262.

11 Shahid Javed Burki, *Kashmir: A Problem in Search of a Solution* (Washington, DC: United States Institute of Peace, 2007).

12 “India GDP Growth Rate in last 10 years: 2003-2013,” *InvestorZclub* (blog), May 31, 2013, http://www.investorzclub.com/2013/05/india-gdp-growth-rate-in-last-10-years.html.

WHAT SPURS MILITARY SPENDING?

There are two aspects to this discussion. The first relates to the external environment, regional politics, and geopolitical aspirations. The other aspect pertains to the internal security environment and capacity to cope with the complex and often conflicting aspirations of the world's densest and largest population grouping. The first aspect is easier to deal with as it mostly pertains to military expenditures. We have to deal with the more complex question: is military spending out of control or is it just adequate?

Military expenditures in South Asia, given its myriad social and economic problems, evoke a great sense of outrage among many, both within and outside the region. The guns versus butter arguments still rage furiously. It may be pertinent to recall the eloquent words that US President Dwight D. Eisenhower made on April 16, 1953:

> "Every gun that is made, every warship launched, every rocket fired signifies, in the final sense, a theft from those who hunger and are not fed, those who are cold and are not clothed. The world in arms is not spending money alone. It is spending the sweat of its laborers, the genius of its scientists, and the hopes of its children...This is not a way of life at all, in any true sense. Under the cloud of threatening war, it is humanity hanging from a cross of iron."[13]

South Asia's many flashpoints, and most notably between the two nuclear weapon states in the region, suggest a region furiously militarizing. But the facts do not quite support this view, as South Asia accounts for less than 2 percent of the world's military spending. The developed countries account for over 74 percent of the world's military expenditure with the United States alone accounting for 47 percent of this. According to Stockholm International Peace Research Institute (SIPRI), in 2011 the world spent over $1,738 billion on its militaries. The expenditure after the US' war in Iraq and NATO's war in Afghanistan is now believed to be

World Military Spending, 2012

Region	Spending ($ b.)	Change (%)
Africa	39.2	1.2
North Africa	16.4	7.8
Sub-Saharan Africa	22.7	-3.2
Americas	782	-4.7
Central America and the Caribbean	8.6	8.1
North America	708	-5.5
South America	65.9	3.8
Asia and Oceania	390	3.3
Central and South Asia	59.8	-1.6
East Asia	268	5.0
Oceania	28.2	-3.7
South East Asia	33.7	6.0
Europe	407	2.0
Eastern Europe	100	15
Western and Central	307	-1.6
Middle East	138	8.3
World total	**1756**	-0.4

The spending figures are in current (2012) US dollars.

Source: "Military Expenditure," *SIPRI Yearbook 2013*, http://www.sipri.org/yearbook/2013/03.

Top Fifteen Countries with Highest Military Expenditure, 2012

Rank			Spending,	Change (%)		Spending as a share of GDP (%)[a]	
2012	2011	Country	2012 ($ b.)	2011–12	2003–12	2012	2003
1	1	USA	682	–6.0	32	4.4	3.7
2	2	China	[166]	7.8	175	[2.0]	[2.1]
3	3	Russia	[90.7]	16	113	[4.4]	[4.3]
4	4	UK	60.8	–0.8	4.9	2.5	2.5
5	6	Japan	59.3	–0.6	–3.6	1.0	1.0
6	5	France	58.9	–0.3	–3.3	2.3	2.6
7	8	Saudi Arabia	56.7	12	111	8.9	8.7
8	7	India	46.1	–0.8	65	2.5	2.8
9	9	Germany	[45.8]	0.9	–1.5	[1.4]	1.4
10	11	Italy	[34.0]	–5.2	–19	1.7	2.0
11	10	Brazil	33.1	–0.5	56	[1.5]	1.5
12	12	South Korea	31.7	1.9	44	2.7	2.5
13	13	Australia	26.2	–4.0	29	1.7	1.9
14	14	Canada	[22.5]	–3.9	36	[1.3]	1.1
15	15	Turkey[b]	[18.2]	1.2	–2.1	2.3	3.4
		World total	**1 753**	**–0.5**	**35**	**2.5**	**2.4**

[ ] = SIPRI estimate.

Source: "Trends in World Military Expenditure, 2012," SIPRI, April, 2013, p. 2, http://books.sipri.org/files/FS/SIPRIFS1304.pdf.

13 Dwight D. Eisenhower, "Chance for Peace," address delivered to the American Society of Newspaper Editors, Washington, DC, April 16, 1953, http://www.eisenhower.archives.gov/all_about_ike/speeches/chance_for_peace.pdf.

over $1.5 trillion.[14] On the other hand, the developed countries and particularly the United States may very well be able to afford these huge expenditures, but can South Asia continue to do so even at the quantum it does without impacting the future prospects of its teeming millions?

The end of the Cold War did not see any let up in military spending. The slight drop seen in the mid 1990s was due to the collapse of the Warsaw Pact and disintegration of the Soviet Union. Russia is back on track now getting rich on oil exports and its renewed interest in world affairs has begun to see commensurately rising military expenditures. The SIPRI tables below underline this disparity in spending. The US and Europe together spend $1,243 billion.

Given below are two sets of data organized by SIPRI and the IMF respectively. Both indicate a high bias toward military expenditure when compared to expenditures on health and education. Whatever people may conclude from this, they must bear in mind that Asia and Oceania data includes Australian expenditures. Australia spends almost 4.6 percent of its GNP on its military, which is the highest in the region. Its per capita military spending puts it right on top with the world's top military spenders like the United States, United Kingdom (UK), France, Germany, Japan, and Canada.

One thing is certain: However little by comparison South Asia may be spending on its militaries, it may still be far too much given its huge socioeconomic problems and even when compared with other similar developing countries, such as Indonesia, which spends only 1 percent of its GDP on the military.

14 $806 billion for Iraq; $444 billion for Afghanistan; $29 billion for enhanced security; and $6 billion unallocated. Amy Belasco, *The Cost of Iraq, Afghanistan, and Other Global War on Terror Operations Since 9/11* (Washington, DC: Congressional Research Service, March 29, 2011).

MILITARY EXPENDITURES IN SOUTH ASIA, GIVEN ITS MYRIAD SOCIAL AND ECONOMIC PROBLEMS, EVOKE A GREAT SENSE OF **OUTRAGE** BOTH WITHIN AND OUTSIDE THE REGION.

Within South Asia, the big spender is India, its biggest nation and greatest economy. Not only is India the biggest military spender in Asia, it is the world's greatest importer of weapons and last year accounted for 13.5 percent of global imports. Yet there are many in India who believe that India punches well below its weight and needs to further strengthen itself. India's military expenditure has been rising steadily and has now reached almost $37 billion. This figure however does not include its spending on its paramilitary forces, which together number about a million. (Neither India nor Pakistan include military pensions in their official defense spending data provided to the IMF; personnel costs are a substantial portion of their military expenditures.)

The table below illustrates this trend quite vividly. But we must bear in mind that India's defense expenditure

Recent Defense and Central Government Expenditures in India

(All figures in tens of millions of In. Rupees unless otherwise noted.)

	2011-12 Actual	2012-13 Budget Estimate	2012-13 Revised Estimate	2013-14 Budget Estimate
Defense Revenue Expenditures	103,011	113,829	108,925	116,931
Defense Capital Expenditures	67,902	79,579	69,579	86,741
Total Defense Expenditures	170,913	193,408	178,504	203,672
Total Central Gov't Expenditure	1,304,365	1,490,925	1,430,825	1,665,297
Gross Domestic Product (GDP)	8,974,900	10,158,900	10,028,100	11,371,900
Defense Spending as Percentage of Total Spending	13.10%	12.97%	12.47%	12.23%
Defense Spending as Percentage of GDP	1.90%	1.90%	1.78%	1.79%

Source: Institute for Defense Studies and Analyses, 2013.

SOUTH ASIA'S MANY FLASHPOINTS SUGGEST A REGION **FURIOUSLY MILITARIZING.** BUT SOUTH ASIA ACCOUNTS FOR **LESS THAN 2 PERCENT** OF THE WORLD'S MILITARY SPENDING.

in 2013 is down to 14.06 percent of the central government's annual budget and is well down from the high twenties of the previous decade. Nevertheless the expenditures on health and education pale into insignificance compared to defence. In 2007 the defense budget dropped below 2 percent (1.99 percent) of the GDP for the first time. This caused a great deal of disquiet in India's strategic community which has been harking upon the 3 percent of GDP envisaged by the national planners and leaders in the previous decades. It is also worth noting that at its current level of military spending India is at less than half the levels of its perennial rivals China and Pakistan. This declining trend has become more pronounced since 2004-5. It is also worthwhile to note that India's military spending as a proportion of GDP is now well below the global level.

As Laxman K. Behera, in a commentary on the declining trend in India's military expenditures for the New Delhi-based Institute for Defense Studies and Analysis (IDSA), puts it:

> "The modest increase in the defence budget comes in the wake of high inflationary and unfavourable exchange rate regimes. As the *Economic Survey* brings out, the average inflation rate during the first nine months of 2012-13 was high at 7.6 per cent and 10 percent, measured in terms of Whole Sale Price Index (WPI) and Consumer Price Index-New Series (CPI-NS), respectively. Even assuming a one-percentage reduction in annual inflation in 2013-14, which is quite optimistic, the real growth of the new defence budget is still in the negative—by 1.3 percent and 3.7 percent in terms of WPI and CPI-NS, respectively. The negative real growth in the defence budget is further worsened by a high exchange rate, particularly with respect to the US dollar which at Rs. 54.5 per unit is still 14 percent higher than in 2012-13."[15]

Pakistan's current government expenditures have been far greater than its revenues since the 1970s. As a result it has been running fiscal deficits and witnessed a growth of public debt that hobbled its attempts to provide social and economic development funding to meet the rising needs of its growing population. Debt servicing and defense spending account for the largest share of its budgets in the period since the 1970s. Subsidies of poorly run state enterprises have increasingly challenged these two headings in terms of their share of the budget. Defense spending has been always been given the highest priority. At the time of independence, it accounted for some 85 percent of the central government's revenues and continued to exceed development spending by a wide margin.[16] Foreign aid, especially from the United States, filled the gap and kept the growth of defense spending to just above 3 percent per annum in the period up to the 1965 war with India. This spending spiked after the war. US aid was cut off. Defense spending nearly doubled between 1960-65 and 1965-70 while development spending suffered.[17] The trend continued in the 1970s, when during the military regime of General Zia ul Haq, defense spending rose at a real rate of over 9 percent per annum, leaving development spending far behind, reaching 6.7 percent of GDP in the final two years of Zia's rule 1987-88. There was a decline over 1988-96 to 5.5 percent of GDP but the imbalance between defense and development spending persisted and remains in effect until today.

15 Laxman K. Behera, "India's Defence Budget 2013-2014: A Bumpy Road Ahead," IDSA Comment, Institute for Defense Studies and Analyses, March 4, 2013, http://www.idsa.in/idsacomments/IndiasDefenceBudget2013-14_lkbehera_040313.

16 Parvez Hasan, *Pakistan's Economy at the Crossroads: Past Policies and Present Imperatives* (Karachi: Oxford University Press, 1998), p. 38.

17 Ibid., p. 6.

DETERMINANTS OF MILITARY SPENDING

Military expenditures are an outcome of many factors. Some of these are national notions about one's place in the world: neighborhood situation; internal political dynamics; assessment of long-term interests and perceptions of geopolitical evolution; and lastly, the internal security situation within a country.

National notions are seldom related to any real security threat. Take the United Kingdom for instance. What plausible threats does that country face for it to maintain large and expensive military forces and a nuclear arsenal? Does it face a threat from France or Russia? Quite clearly Britain's military posture is dependent on its notions of its place and role in world affairs, even if it were a trifle exaggerated.

On the other hand, India or Pakistan's military expenditures depend on how they perceive the threats emanating from each other. They live in inimical neighborhoods. India, for instance, has Pakistan and China to constantly contend with. Pakistan's military justifies its expenditures based upon Indian budgets, India upon China's, and China upon some others, including the United States and Japan.

Often the internal political dynamics will determine the role and place of the military in a nation's life. It is only logical to expect a military-centric view to prevail if a country's military has a major role in its government. Pakistan, for instance, cannot expect the military to accept anything less than it has so long been used to. Since the military is a significant and active player in Pakistani politics and government, a good deal of its expenditures may also owe to the military being able to realize a good part of its wish list of equipment, stores and amenities. Pakistan's situation differs from India's, where the military is a mere agency well removed from policymaking.

Increasingly in Pakistan, the military, which is a major participant in the economy by virtue of its commercial holdings and the investments of the Fauji Foundation and the Army Welfare Trust, has become deeply concerned about the economy as a whole. A shrinking economic pie would reduce its own access to resources as well as the profitability of the commercial ventures that it runs. While it continues to view India as a potential threat to Pakistan, the military reportedly did open the door to trade talks with India under the recently removed government led by the Pakistan People's Party. How committed it is to this stance remains to be seen.

Countries usually trade with their neighbors. The US' biggest trade partner in 2012 was Canada, with a bilateral trade of $597.4 billion. This has been so even in the years before when China emerged as a significant US trade partner. In 2012 US-China trade was $503.2 billion. But closely following China was another immediate US neighbor—Mexico, with $480.6 billion.[18]

Across the Atlantic, too, the experience is almost the same for France's foreign trade. Of its exports of 456.8 billion euros, Germany (14.3 percent), Italy (8.7 percent), Spain (8.3 percent), and UK (7.8 percent) accounted for about 40 percent. Of its 532.2 billion euros worth of imports Germany (17.9 percent), Belgium (11.7 percent), Italy (8.3 percent) and Spain (6.9 percent) accounted nearly half. While for Germany, France was its top export market (101 billion euros); Holland (82 billion euros) was its biggest source of imports.

While quite expectedly the United States was China's biggest trading partner accounting for $374.76 billion of its international trade of almost $3 trillion, its immediate neighbors Japan ($256.29 billion), Hong Kong ($266.05 billion), South Korea ($197.88 billion) and Taiwan ($145.4 billion) are all major trading partners. This is significant when one consider that China does not enjoy the best of relations with all of them except, understandably Hong Kong.[19]

18 US Department of Commerce, "Top U.S. Trade Partners Ranked by 2012 U.S. Total Export Value for Goods," http://www.trade.gov/mas/ian/build/groups/public/@tg_ian/documents/webcontent/tg_ian_003364.pdf/.

19 European Commission, "European Union, Trade in Goods with China," September 2006, http://trade.ec.europa.eu/doclib/docs/2006/september/tradoc_113366.pdf.

INTRAREGIONAL AND BILATERAL TRADE

Intraregional trade accounts for roughly 65 percent of European Union's total trade; it is 51 percent in the North American Free Trade Agreement (NAFTA) area, 25 percent in ASEAN and 16 percent in the Latin American trade bloc, Mercosur. However, this ratio is about 5 percent in the South Asian Free Trade Area (SAFTA) despite the existence of logistical advantages. As South Asia's biggest economy India would have been expected to show its trade with neighbors as an important economic activity. But not so. While the share of South Asia in India's exports has risen somewhat modestly from 4.70 percent in 2000 to 5.13 percent in 2010, India's imports from South Asia have dropped quite significantly from 1.10 percent in 2000 to 0.60 percent in 2010.

As the *Economist* presciently notes:

> "South Asia is about the least integrated part of the world. Neighbors supply just 0.5% of India's imports, and consume less than 4% of its exports. India and Pakistan, mutually antagonistic, account for a fifth of all living humans, yet their bilateral trade is puny, at less than $3 billion a year... This is an economic as well as a diplomatic problem. Lack of integration helps to keep South Asians poor. By one estimate, without barriers trade between India and Pakistan would grow nearly tenfold."[20]

20 "India and its Near-abroad: The Elephant in the Region," *Economist*, February 18, 2012, http://www.economist.com/node/21547795.

India-Pakistan Bilateral Trade

India's bilateral trade with Pakistan likewise is beginning to dwindle. In 2007-8 Pakistan accounted for 1.20 percent of India's exports and 0.1 per cent of its imports. In 2012-13 these have become 0.52 percent and 0.14 per cent respectively. Bruce Reidel writing in the *National Interest* has this to say,

> "Today, direct trade between the two nations is relatively small. The total trade between Pakistan and India in 2011 was $2.6 billion. In 2010, India exported about $2 billion to Pakistan and imported about $300 million. This is twice the amount in 2006 and almost ten times larger than 2001, but it's still fairly small.... Indirect trade (usually via Dubai or Singapore) is much greater but very hard to quantify."[21]

In recent years the emergence of the UAE as India's second major trading partner with a bilateral trade in merchandise goods worth $72 billion puts it just behind the India-China trade of $76 billion. The port of Dubai has a justifiable reputation of being an export trans-shipment hub. It has over the years acquired a special expertise on facilitating exports and imports of goods produced by inimical nations. Thus many Israeli

21 Bruce Riedel, "Toward an India-Pakistan Détente," *National Interest*, October 25, 2012, http://nationalinterest.org/article/toward-india-pakistan-detente-7667.

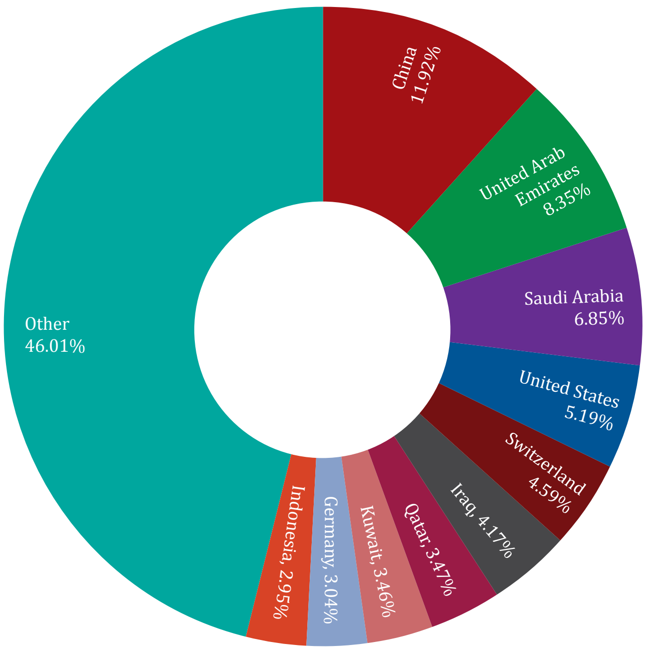
Trade within Regional Blocs

(Percentage of Total Exports)

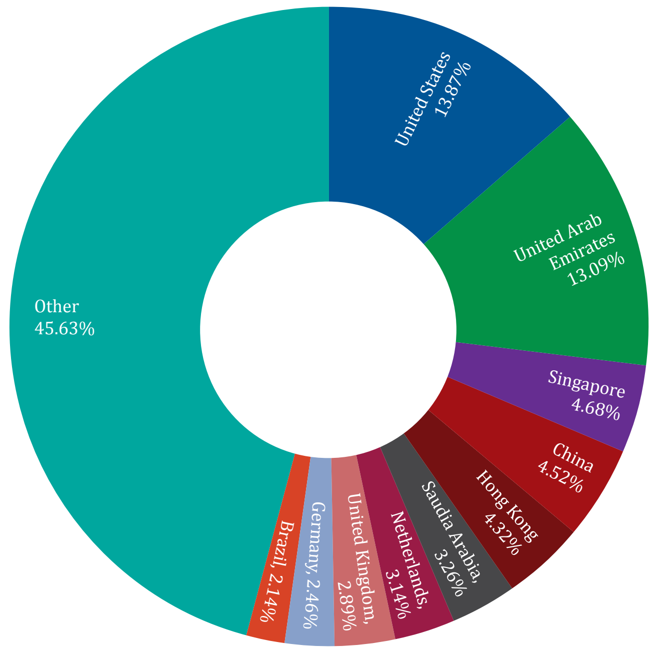
	1990	1995	2000	2005	2009
South Asian Association for Regional Cooperation	3.5	4.5	4.6	6.6	5.4
Association of Southeast Asian Nations	18.9	24.4	23.0	25.3	24.5
East African Community	17.7	19.5	22.6	18.0	18.9
Central American and Caribbean Market	15.3	21.8	19.6	23.2	22.3
Commonwealth of Independent States	—	28.4	19.8	17.7	14.8

Source: SAARC Secretariat, Kathmandu.

India's Trade Partners



Top Ten Exporters to India



Top Ten Importers from India

Source: "India's Trade: Full List of Exports, Imports and Partner Countries," Datablog, *Guardian*, February 22, 2013, http://www.theguardian.com/news/datablog/2013/feb/22/cameron-india-trade-exports-imports-partners#data.

agricultural products are repackaged in Dubai for reexport to Arab nations. Similarly it is now believed that a sizable volume of India's trade with the UAE is actually goods in transit to Pakistan and vice versa.

In his study *The Battle of Dubai*, Karim Sadjapour of the Carnegie Endowment for International Peace points out that Indian manufactured goods form the biggest chunk of Dubai's reexports, based on data from UAE Ministry of Foreign Trade statistics.[22] In 2010 this reexport was worth $14.22 billion, or 28.22 percent of the total. The UAE was India's largest export destination in 2010, with total exports worth $23.97 billion dollars.[23] Since India has consistently maintained trade with Iran and in 2010 this amounted to $1.85 billion.[24] Even after assuming that there is still some reexport of certain embargoed items to Iran, it is clear that the bulk of the reexport is destined elsewhere, mostly to Pakistan. How much this is worth is open to much speculation.

22 Karim Sadjapour, *The Battle of Dubai: Arab Emirates and the U.S.-Iran Cold War* (Washington, DC: Carnegie Endowment for International Peace, July 2011), http://carnegieendowment.org/files/dubai_iran.pdf.

23 "India, China Dominate Exports to UAE," *Hindu*, http://www.thehindu.com/business/Economy/india-china-dominate-exports-to-uae/article526709.ece.

24 As the Federation of Indian Chambers of Commerce and Industry (FICCI) put it, "The detailed trade statistics on our trade with Iran (given below) provide an idea of the scope that exists in this market. The two-way trade between India and Iran has shown good growth in recent years. In fact, it has grown more than 25 percent during the last five years from US$ 12887.52 million in 2007-08 to US$ 15968.03 million in 2011-12. India's export to Iran has grown more than 25% from about US$ 1943.92 million in 2007-08 to US$ 2411.33 million in 2011-12. Iran's exports to India during these years have registered an increase of almost 30% from US$ 10943.61 million in 2007-08 reaching US$ 13556.71 million in 2011-12. The trade balance continues to be in Iran's favour, although India's imports are also increasing as well." FICCI, "India–Iran Economic Relations," http://www.ficci.com/international/75186/Project_docs/India-Iran-Economic--Relations.pdf.

WHAT DOES IT COST?

Whatever this figure might eventually be determined to be, direct trade with India may hold significant benefits for both countries. India is one of the largest world exporters of cut diamonds. Most of the diamonds imported by Pakistan are cut in India. According to Dineshbhai Navadiya, president of the Surat Diamond Association, "Presently, India does not export diamonds to Pakistan directly. Pakistani diamond buyers, however, import Indian-cut and polished diamonds via Dubai or Hong Kong. Industry reports suggest that diamonds imported to Pakistan via Dubai or Hong Kong cost nearly 10-15 per cent more than direct import from India."

Whatever the quantum of such benefits, there is little doubt that both sides will hugely benefit from an expansion of bilateral trade. According to some estimates this has the potential of growing to $40 billion in just a few years. In a recent issue the Indian newsweekly *Outlook* reported Ijaz Nabi, a former World Bank economist, as saying:

> "If Pakistan wants to play its historical geo-strategic role as a trade hub, it cannot do so without trade with India. If it revives the historic east-west and north-south trade routes, this could be a major source of growth for the next four to five decades. India has a larger role to play in making south Asia—home to much of the world's population—a vibrant economic region."[25]

Anita Batra with the Indian Council for Research on International Economic Relations (ICRIER) has shown that a fivefold increase in trade between the two countries is possible from the present $2 billion a year if the trade regime between the two counties were normal.

But more crucially a State Bank of Pakistan (SBP) study has revealed that for 48.7 percent of the items imported in 2004, the unit values of Pakistan's imports were more than the unit values of imports from India. This report further goes on to state that "even after excluding the items which are currently permissible for imports from India, about 45 percent of the items still remain on the common list, which could be imported from India at a lesser cost than the current cost of imports from the rest of the world. Allowing imports of such items from India will give Pakistan an average savings of $400 to $900 million."[26] How much does the non-fulfillment of trading potential between India and Pakistan cost the two countries in terms of GDP, job losses, and investment? One thing is clear: neither of the two countries can afford to ignore such losses.

As Japan and China are showing us, trade is indeed possible between two otherwise inimical nations. They also show us that trade is inevitably followed by investment. India is now a major investor country. According to the Exim Bank of India in 2012 India invested $14.6 billion in neighboring countries, mainly in the manufacturing and infrastructure areas. In a recent recent speech Harun R. Khan, deputy governor of the Reserve Bank of India said:

> "A trend analysis shows that the level of outward FDI from India has increased manifold since 1999-2000. The level of net outward FDI flows (on BoP basis), however, recorded a sharp uptrend at $74.3 billion during the second half of 2000s (2005-06 to 2009-10) as compared to $8.2 billion in the first half of 2000s (2000-01 to 2004-05). Even though trend in India's outward foreign direct investment (FDI) was moderately affected during crisis year of 2009-10, a sharp rebound was seen in 2010-11."[27]

Pakistan whose investment-to-GDP ratio of 18.9 should cause it concern—compared to India's 33.7—could benefit some with Indian investment too. The difference in investment rates should somewhat explain the huge asymmetry between India and Pakistan. If India's GDP currently is seven times that of Pakistan, in real terms what this means is that while Pakistan is able to invest only about $18 billion a year, India is able

25 Bharat Bshushan, "With Kim, on the Old Grand Trunk," *Outlook*, June 18, 2012, http://www.outlookindia.com/article.aspx?281240.

26 State Bank of Pakistan, Research and Economic Policy Department "Implications of Liberalizing Trade and Investment with India," 2006, http://www.sbp.org.pk/publications/pak-india-trade/.

27 Harun R. Khan, "Outward Indian FDI—Recent Trends & Emerging Issues," address delivered by Khan, deputy governor, Reserve Bank of India at the Bombay Chamber of Commerce & Industry, Mumbai, March 2, 2012, http://rbi.org.in/scripts/BS_SpeechesView.aspx?Id=674.

to make an investment of 33.7 percent out of a GDP of $1.3 trillion or about $438 billion.

Beyond trade, greater economic integration of the region that the two countries reside in would produce benefits to them and other countries of the region. As Toufiq A. Siddiqui argues, "Peace could bring a wide range of benefits not only to India and Pakistan but to the wider region as well. For example, it could enable cooperation on importing energy via a natural-gas pipeline [from Iran and Central Asia], which would support environmentally sound development." Such cooperation would lead to improved infrastructure and intra-regional trade in the region, according to Siddiqui.

Siddqui contends that an India-Pakistan detente would create the atmosphere for cooperation on a wide range of issues, including:

- "Estimating future energy requirements, assessing options for meeting them, and identifying the most economical and environment-friendly ones.
- Establishing a mechanism for local investors to work with multilateral funding agencies. Large-scale energy projects are more likely to succeed if local people have a vested interest in them—for example, if small shareholders in India, Pakistan, and neighboring countries substantially owned a pipeline company.
- Examining options for improving air quality, along with their costs and social/political implications, and suggesting strategies for urban and rural areas.
- Encouraging countries to pool their technological expertise."

The South Asian Association for Regional Cooperation (SAARC) and its various subgroups have begun discussing some of these issues. Strained relations between the two largest countries in the region have prevented much progress in the past, and the current thaw provides a great opportunity to move forward.

In addition to conventional weapons development, both India and Pakistan have invested heavily in developing nuclear weapons and are continuously developing new and improved delivery vehicles, including now so-called tactical nuclear weapons.

It is to be pointed out that Pakistan and India are the only two nuclear armed states who still have unresolved disputes. The nuclear armed neighbors clearly play out Glenn-Snyder's stability-instability paradox with two sides viewing limited wars as permissible. Pakistan has been guilty of testing India's "red-lines" during the Kargil conflict in 1999, the attack on the Indian Parliament in 2001-2002, and the

THERE IS LITTLE DOUBT THAT BOTH SIDES WILL BENEFIT HUGELY FROM AN EXPANSION OF BILATERAL TRADE. ACCORDING TO SOME ESTIMATES THIS HAS THE POTENTIAL OF GROWING TO $40 BILLION IN JUST A FEW YEARS.

Mumbai attacks in 2008. India's growing conventional advantage will force Pakistan to rely heavily on its nuclear deterrent and similarly India's acquisitions such as the ballistic missile defense capabilities will also arguably push Pakistan to augment its offensive capabilities thus resulting in an endless cycle that may be a huge drain on Pakistan's economy.

Pakistan is prompted in this direction by India's larger military size and capability. The US National Intelligence Council has estimated that by 2030 India's economy will be sixteen times the size of Pakistan's. This will exacerbate the military imbalance for Pakistan, whose conventional forces are a fourth the size of India's today. Pakistan sees nuclear weapons as the equalizing factor. India meanwhile sees a rising threat from China and its nuclear weapons are also aimed at providing a deterrence and to meeting that potential threat. Nuclear weapon testing and development has added a new and significant cost to the budgets of both countries. Both favor the objective of Global Zero (the effort to eliminate nuclear weapons worldwide) but have not shown any inclination to stop their nuclear race till the developed world signs up for that objective and implements it.

It will require bold leadership in both countries to turn back the tide of conflict and provide for their peoples a brighter and peaceful future.

RECOMMENDATIONS

Militarily, both India and Pakistan could reduce the proximity of their land forces by increasing the distance from borders of their respective forces. Pakistan has already culled some of its eastern forces to enhance its military presence on its western front. Greater direct exchanges between the two militaries would build confidence in each other's intentions and capabilities both. Visits to each other's training establishments would allow them to verify shifts in thinking and also create the possibility of sharing experience in fighting irregular groups and insurgents.

The nub of the India-Pakistan conflict is the dispute over Jammu and Kashmir. Its acrimony is felt in all international forums where the two nations meet. Kashmir remains a potential global flashpoint that could escalate into a nuclear war very quickly.

India has a similar conflict with China over huge tracts of territory. The countries have fought twice, in 1962 and 1967 over this. But a practical modus vivendi has existed since then. The two countries maintain normal relations and have agreed not to resort to force to settle the dispute. Both have detailed arrangements, formalized by agreements, which are expressly aimed at preventing recourse to force. There is a standstill that prevails. Both have agreed that they will negotiate their way to a settlement at some future date. The bilateral trade between the two countries is now in excess of $72 billion and is expected to cross $100 billion by 2015. Whether a similar agreement can be worked out between India and Pakistan is the tantalizing question. In November 2003 the two countries had entered into a cease-fire agreement that effectively terminated the nightly exchange of fire between the two armies. While this did not result in the thaw that many had hoped for, some resumption of India-Pakistan intercourse in a number of fields were evident. Both countries stepped up sporting and cultural exchanges, and travel became somewhat easier.

Even short of this a number of actions are available to both countries to reduce barriers on the politico-economic front as well as alter their military calculus. Both would profit enormously from becoming more integrated in the regional trade of South Asia. This involves opening borders to easier movement of people and goods, benefitting from joint investments in infrastructure, including transport, power, and water.

The bilateral trade between India and Pakistan can easily evolve into a major economic factor, if both countries seriously proceeded with it. While India and Pakistan may still be far away from evolving open borders to allow people to move freely, they could have open borders for trade. A big bilateral trade then invests in the peace constituencies in both countries. Business relationships make nations more pragmatic and accommodating. India and Pakistan seriously need to invest efforts in expanding trade and investment to the fullest extent possible. An annual bilateral trade between India and Pakistan may result in a GDP trajectory that could be as much as 1.5 percent more than present. This will represent a fourfold increase in trade and both sides have much to gain in terms of lower prices and timely supplies. India's growing demand for fruits and vegetables will give Pakistani farmers a much larger market and assure them of better prices also.

KASHMIR REMAINS A POTENTIAL GLOBAL FLASHPOINT THAT COULD ESCALATE INTO A **NUCLEAR WAR** VERY QUICKLY.

A more cooperative climate will also enable both countries to jointly develop hydroelectric power in the Indus basin. If the Indus basin is treated as a single economic unit, then it has the effect of overlaying economic logic over political divisions. It is estimated by some that as much as about 8,000 MW of power can be generated by jointly managing the basin and by selling power to each other. This by itself creates a vested interest in managing the natural resources of the watersheds more efficiently and with greater diligence.

CLEARLY THERE IS MUCH INDIA AND PAKISTAN CAN DO TO BRING PROSPERITY TO THEIR PEOPLE FASTER IF THEY **WORKED TOGETHER** TO BUILD THEIR ECONOMIES.

Another major area of cooperation could be in developing an oil and gas grid that connects the exporters of hydrocarbons like Iran, the Middle East, and Central Asia to the markets in India and Pakistan. At present a gas pipeline between Iran, Pakistan and India is under discussion. Similarly it would be feasible and cheaper for India and Pakistan to collaborate in building pipelines to join them with oil producers like Qatar and Oman.

Clearly there is much India and Pakistan can do to bring prosperity to their people faster if they worked together to build their economies. Economically intertwined and mutually beneficial economic systems in both countries will create a huge peace constituency that will not only be good for the two nations but also for the region and for the entire world.

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