

FALLING SHORT



HOW BAD ECONOMIC CHOICES THREATEN THE US-INDIA RELATIONSHIP AND INDIA'S RISE

By Sadanand Dhume and Julissa Milligan
with Aparna Mathur and Hemal Shah



A M E R I C A N E N T E R P R I S E I N S T I T U T E

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Executive Summary

Two decades after the end of the Cold War, US–India relations stand at a crossroads. Not so long ago, many in Washington viewed the signing of the historic US–India civil nuclear deal as the advent of a dynamic partnership with the potential to transform Asia and the world.¹ Today US–India ties are just as often characterized as unrealistic or oversold.²

To be sure, successive American and Indian administrations have chipped away at the mistrust that once characterized ties between the world’s two largest democracies. Washington and New Delhi talk to each other more often, about more things, and at higher levels than ever before. The two governments are engaged in more than 30 ongoing dialogues; they discuss everything from Afghanistan and counterterrorism to vocational education and clean cookstoves.³

Republicans and Democrats alike generally agree that the goal of a strong India—as a symbol of democratic capitalism, an implicit counterweight to Chinese hegemony, an ally in the long war against radical Islam, and an engine of global growth—remains worth supporting.⁴ The United States also views stronger ties with India as an essential part of its “rebalance” toward Asia.⁵

A strategic partnership built on weak foundations will likely flounder, however. Economic and trade ties, which ought to be the lifeblood of a US–India partnership, have traditionally played second fiddle to strategic considerations and remain far below potential. Moreover, even as the United States remains India’s top trade partner (in goods and services), and US–India trade continues to grow, the importance of the United States to India’s economy may be *declining*.⁶ Since 2004, the share of the United States in India’s total trade has fallen, as has the US share of foreign direct investment (FDI) inflows to India.⁷

Although FDI figures may be disputable—many firms route their investments to India through the tax haven of Mauritius—the lack of progress on a bilateral

investment treaty is not. Simply put, neither country treats the other as a trade priority in Asia. More recently, disputes regarding potential US restrictions on services trade and Indian policies on intellectual property rights, preferential market access, and taxation have roiled the relationship. In June, more than 170 members of Congress wrote to President Obama to express concern about India’s failure to protect intellectual property adequately and its attempts to implement local content requirements in technology purchases.⁸

It does not help that over the past 18 months, India’s economic growth has plunged to 4 percent per year, the lowest level in a decade.⁹ Slowing growth raises questions about whether India will live up to some of the forecasts that have underpinned its rise to strategic prominence in Washington. Last year, the National Intelligence Council estimated that “by 2030 India will be the largest driver of middle class growth on earth and will surpass China in economic dynamism.”¹⁰ The Organisation for Economic Co-operation and Development (OECD) predicts that by 2060, India will account for 18 percent of global economic output.¹¹ Both predictions hinge on sustained high growth.

We argue that the key to fulfilling the strategic potential of the US–India relationship is to foster a vibrant, entrepreneurial Indian economy linked to America by ideas, capital, people, and technology. For the United States, this means remaining true to its own principles of economic freedom when it comes to issues such as services trade, liquefied natural gas exports, and the expansion of multilateral trading regimes. Washington should also recognize the shifting shape of India’s polity by stepping up engagement with India’s best-performing state governments.

For India, the continued deepening of its ties with the world’s sole superpower requires the firm repudiation of antimarket measures that have soured both foreign and domestic investors and a renewed commitment to the

incomplete task of economic reform. In terms of relations with the United States, India ought to prioritize negotiating a high-quality bilateral investment treaty and improving protection for intellectual property rights, conditions for manufacturing and taxation policy. We cannot overstress the importance of commencing nuclear commerce, an unfulfilled promise of the 2008 US–India nuclear deal, to restore trust in India among Washington policymakers. The September 27 announcement by President Barack Obama and Prime Minister Manmohan Singh that India's state-owned nuclear operator has commenced commercial negotiations with US firm Westinghouse to build a reactor in the Gujarat state is a belated but welcome start.¹²

Many of India's most urgent tasks are domestic. Indeed, in interviews with Indian entrepreneurs and business leaders in six major urban centers, what emerged most clearly was near unanimity that they need no special encouragement, merely a government that provides a reasonable environment in which businesses are encouraged to thrive with sufficient infrastructure, minimal corruption and red tape, and a skilled and flexible workforce. In an increasingly federal country, economically backward states will need to take their cues from relatively prosperous and business-friendly states such as Tamil Nadu and Gujarat.

In addition, India needs to address long overdue reforms in land, taxes, labor, and power. We highlight these issues briefly in the second part of this report, based in part on an online survey of nearly 600 Indian businesspeople and entrepreneurs conducted in partnership with the British polling firm YouGov.

Against the backdrop of India's economic slowdown, we urge both Washington and New Delhi to prevent temporary hiccups from derailing what ought to be a deep economic and strategic convergence. But we also recognize that although ultimately the United States and India should aim for a free trade agreement (FTA) and Indian membership in the Trans-Pacific Partnership, for now the more modest goals of a high-quality bilateral investment treaty and Indian membership in Asia-Pacific Economic Cooperation (APEC) are more achievable.

Finally, we recognize that time is not on India's side. After nearly a decade of stuttering reforms, both foreign and domestic investors are looking at India with greater skepticism than at any time since the onset of

liberalization in 1991. Whoever is elected to run India after next year's general elections will have their work cut out for them. The country, which already lags most of East Asia in terms of both income and human development, can scarcely afford to slip behind further. If growth continues to stall, it will jeopardize both the US–India strategic partnership and India's rise as a global power.

We make the following recommendations for the United States:

- *Services Trade:* Amend the comprehensive immigration reform bill to address the concerns of Indian information technology firms.
- *Liquefied Natural Gas (LNG) Exports:* Liberalize LNG export guidelines to allow exports to India (and other non-FTA countries) on a routine rather than case-by-case basis.
- *Asia-Pacific Economic Cooperation:* Back India for full membership in APEC as a step toward eventual inclusion in the Trans-Pacific Partnership.
- *Focus on States:* Recognize a trend toward greater federalism in the Indian economy and deepen relations with the fastest-industrializing states.
- *Bilateral Investment Treaty (BIT):* Negotiate a high-quality BIT as a stepping stone toward a free trade agreement.

We make the following recommendations for India:

- *Bilateral Investment Treaty:* Negotiate a high-quality BIT as a stepping stone toward a free trade agreement.
- *Intellectual Property Rights:* Encourage innovation by increasing the protection of intellectual property rights in line with global norms.
- *Preferential Market Access:* Allay investor concerns

about draconian local content requirements for technology purchases by unambiguously scrapping the suspended preferential market access policy.

- *Taxation Policy:* Reject retroactive taxation and end aggressive collection based on unpredictable and sometimes indecipherable rules.
- *Civil Nuclear Commerce:* Create conditions that allow US firms to participate in India's nuclear industry.

We make the following recommendations for next-generation Indian reforms:

- *Land:* Revisit land acquisition to reflect business concerns about cost and complexity.
- *Goods and Services Tax:* Create a unified Indian market by implementing a long-delayed goods and services tax.
- *Labor and Skills:* Overhaul labor laws to bring more informal workers into the formal sector and revamp the education system toward the modern economy.
- *Power:* End India's chronic power shortages by privatizing loss-generating state electricity boards and ending a government monopoly on coal.

Part I: US–India Economic Relations

Overview

Over the past decade, India has swiftly moved from the periphery toward the center of US foreign policy in Asia. Policymakers on both sides of the aisle in Washington see the potential for a democratic and pluralistic India to act as an engine of global growth, an alternative role model to authoritarian China, a guarantor of stability in Asia, and a bulwark against the threat of radical Islam emanating from Afghanistan, Pakistan, and the greater Middle East. With its British legal and parliamentary traditions, English-speaking elites, and increasingly globalized firms, India is arguably the Asian nation best positioned to partner with the United States in pursuing shared interests ranging from keeping Asia's sea lanes open for commerce to combating piracy to helping deepen democracy in the developing world.

For India, too, facing the twin challenges of an unpredictable and potentially expansionist China and the growth of radical Islam in its neighborhood, forging a closer relationship with the United States is a central goal. As India modernizes an economy hobbled by four decades of socialism, it stands to benefit from a stabilizing American presence in Asia much as East Asian countries such as Korea and Taiwan, and Southeast Asian ones like Thailand and Malaysia, did before it. The 3.1-million-strong Indian-American diaspora, closely linked to India by familial and cultural ties, and the 100,000 Indian students enrolled in American universities, add to the likely outsized role the United States will play in India's modernization over the coming decades.¹³

Over the past 15 years, the two countries have indisputably shed much of the Cold War baggage that, in US diplomat Dennis Kux's phrase, made them "estranged democracies."¹⁴ Washington and New Delhi have established a wide-ranging set of more than

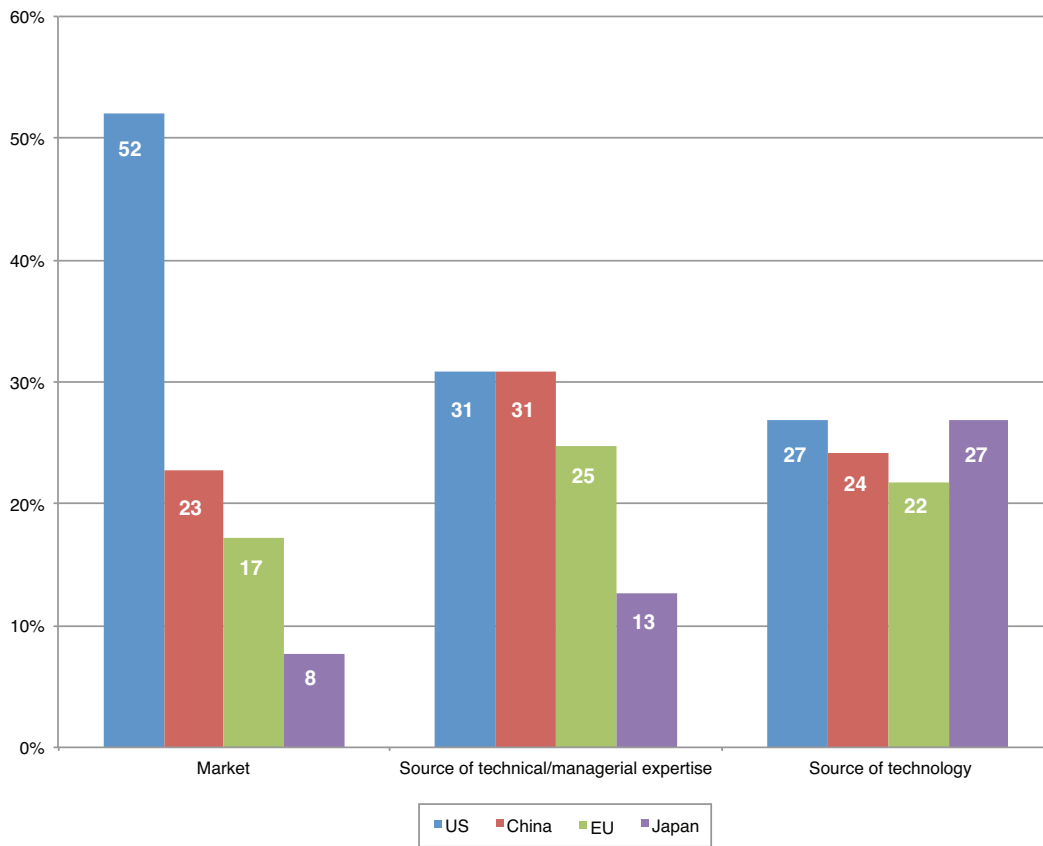
30 dialogues that span everything from Afghanistan and homeland security to energy, education, and the environment. The Indian military exercises more with the United States than with any other country (more than 50 formal events annually).¹⁵ Washington, New Delhi, and Tokyo have institutionalized a trilateral dialogue on regional and global issues at the assistant secretary level.¹⁶ A similar trilateral in South Asia includes Afghanistan.¹⁷

But though the logic of a closer US–India relationship may seem self-evident, and progress toward it inexorable, reality does not always match rhetoric. Simply put, the two countries are yet to establish economic ties worthy of their combined gross domestic product (GDP) of over \$20 trillion (in purchasing power parity terms). In 2012, US–India trade in goods was less than one-eighth of US–China trade of \$536.2 billion.¹⁸ The full potential of the US–India partnership remains stymied by India's failure to live up fully to its economic promise, by relatively weak US–India trade ties, and, more recently, by a series of sharp disagreements on issues ranging from employment visas to intellectual property rights to taxation.

To be sure, when compared with the past, the economic relationship looks robust. Trade in goods and services doubled from \$45.4 billion in 2006 to \$92.3 billion in 2012.¹⁹ Unlike US trade with China, trade with India is more balanced. In 2012, the United States ran a modest deficit of \$10.9 billion.

Cumulative two-way investment topped \$30 billion at the end of 2010.²⁰ Not counting funds routed through Mauritius, the United States has contributed about \$10 billion in foreign direct investment to India since 2000, the most after Mauritius and Singapore, both of which have tax treaties with India that encourage firms to route investments through them.²¹ Ernst and Young estimates that US firms created more than

FIGURE 1
IMPORTANCE OF LEADING ECONOMIES TO INDIAN BUSINESS



Source: AEI/YouGov Survey

355,000 jobs in India between 2007 and 2011.²²

Overall commitment to India of the US Export-Import Bank (Ex-Im), which finances procurement of US goods and services when private financing is unavailable, totaled over \$12 billion in 2012, including funding for a Reliance Industries petrochemicals plant in Gujarat and Air India's purchase of Boeing 787 Dreamliners.²³ For the Overseas Private Investment Corporation, loans for clean energy and solar power have made India its fourth largest portfolio.²⁴ Meanwhile, US defense exports to India have gone from being virtually nonexistent a decade ago to over \$8 billion today, propelled by purchases of military transport and maritime surveillance aircraft from Lockheed Martin and Boeing, heavy lift and attack helicopters from Boeing, and radars from Raytheon.²⁵ (Unless explicitly noted, trade figures in this report do not include defense sales.)

At the same time, the US-India Business Council estimates that Indian firms have cumulatively invested \$11 billion in America and created over 100,000 jobs, mostly in manufacturing and information technology.²⁶ Indian professionals have become an essential part of the US economy. Last year, Indians received over 80,000 H-1B (work) visas, nearly 60 percent of the total issued, and nearly one-third of all L-1 visas (intracompany transfer).²⁷ Among the beneficiaries of these programs have been Indian engineering graduates and the US economy. Indian immigrants, who make up less than 1 percent of the US population, have founded 13.4 percent of Silicon Valley startups.²⁸

Indian business sentiment toward the United States also remains overwhelmingly positive. Of the participants in the AEI/YouGov survey whose companies have an international footprint, roughly four-fifths see the

United States as important for their business, compared to about two-thirds who feel similarly about China.

Indeed, for the Indian businesses surveyed (figure 1), the United States stood out as the most important market source of technical and managerial expertise and technology (though it tied with China as a source of technical/managerial expertise and with Japan as a source of technology). About four-fifths of the respondents see America becoming even more important to their business 10 years from now, though this sentiment reflects a broader sense that global trade will continue to grow in importance for Indian firms.²⁹ In Bangalore and Hyderabad, Indian technology entrepreneurs look to Silicon Valley for venture capital, networks, markets, and inspiration.³⁰

This enthusiasm notwithstanding, India is only America's 13th largest trading partner, falling between the Netherlands and Venezuela.³¹ The United States is India's top trading partner including goods and services (\$92.3 in 2012),³² but in goods alone India's trade with China (\$65.1 billion) is larger than with the United States (\$63.2 billion).³³ Nor does US–India trade reflect essentially complementary economies: the United States is rich with capital and technology, while India boasts a massive workforce and first-rate managers, engineers, and scientists.³⁴ The goal of \$500 billion in bilateral trade, proposed by Vice President Joe Biden at the Bombay Stock Exchange in July, and by Commerce and Industry Minister Anand Sharma the same month in Washington, remains distant.³⁵

Moreover, evidence suggests that US importance to India's economy may be declining. The share of US trade as a proportion of total Indian trade fell from 10.6 percent in 2004 to 7.5 percent in 2011.³⁶ The aggregate US share of foreign direct investment (FDI) flows to India plunged even more dramatically, from 20.8 percent in 2004 to 6 percent in 2010.³⁷ Some of this is likely reflected by US firms (like others) choosing to route their investments through Mauritius for tax purposes and the (welcome) deepening of India's links with other economies in Asia and Latin America. But, at least in part, this decline also reflects an Indian web of trade treaties that effectively disadvantages US firms compared to others.

Until now, Washington has viewed the US–India relationship largely through a strategic prism, advancing

it through political methods such as supporting an Indian seat on an expanded United Nations Security Council or creating an exception for India in the global nonproliferation regime through a deal on civil nuclear cooperation. To be sure, this view of India takes into account the country's robust economic growth since the advent of liberalization, but it does not make business and trade central to the relationship.

*The US–India Business Council estimates
that Indian firms have cumulatively
invested \$11 billion in America and
created over 100,000 jobs.*

This is a mistake. Articulating US strategic interests at a largely government-to-government level makes them prey to the vagaries of the moment, and too often a victim of old thinking in New Delhi and shortsightedness in Washington. And when disagreements arise, whether on geopolitical issues such as Iran or Afghanistan or on economic ones like immigration or taxation, the absence of private sector links comparable to American ties with Japan or South Korea makes them harder to overcome.

Moreover, India's rise as a major power, and its ability to perform the role that its strategic elites as well as many well-wishers in the United States would like to see it play, depends in large part on its economy. Instead of the economic component of the US–India relationship taking a backseat to the strategic component, it ought to be the other way around.

This insight is at the heart of this report. Indeed, India's relative success over the past two decades—that it has begun to matter to US policymakers after decades of irrelevance—can be traced directly to economic reforms. But although India has stepped up GDP growth rates and freed private businesses from the most draconian aspects of socialist-era regulation, much more remains to be done.³⁸

At a philosophical level, India's political elites need to recognize that the country's recent economic troubles are traceable to a continued ambivalence toward free markets and private enterprise. In practical terms, renewed

and sustainable growth will require scrapping regressive labor laws that discourage businesses from hiring workers; further opening up sectors of the economy such as retail, banking, and insurance to foreign capital; and simplifying regulations that stifle entrepreneurship by making it difficult to start a new business or shutter a failing one. India must also seek ways to speed up the spread of a culture of entrepreneurship from the prosperous coastal regions to the backward hinterland.

For its part, the United States needs to recognize that a belief in democracy and shared concerns about potential Chinese hegemony in Asia and the spread of radical Islam are not enough to build a deeper relationship with India. This means encouraging India to make the kinds of policy changes that will make private businesspeople, rather than government bureaucrats, the principal bridge between the two nations. Over the years, US leaders from the president downward have generously lavished praise on India. As the country's business climate deteriorates sharply, perhaps it is time to leaven future statements with a dose of well-intentioned criticism as well.

This also requires remaining true to America's own free-market principles in navigating economic relations with India. An enlightened foreign policy will curb the natural instinct of trade and economic bureaucracies to demand tit-for-tat concessions while at the same time actively pursuing American interests. It will also place broader principles such as lower tariffs, more transparent regulations, and rule of law ahead of championing the interests of individual firms. In dealing with India's raucous democracy, where socialism has been weakened but not vanquished, free enterprise must continue to hold the moral high ground. In short, the United States has a stake in access to India's market. But it has a bigger strategic stake in the emergence of India as a market economy.

On issues such as natural gas exports and work visas, the United States should not cut off its nose to spite its face in response to India's restrictive policies. Instead, it ought to include the power of example among the tools it uses to persuade India to pursue further economic reforms. In sum, making India a more market-friendly economy ought to be the central focus of US policy in South Asia—without it all other goals are likely to fail.

A strong India is in America's strategic interest, as this will enable India to pursue a more prominent

role in the world in ways that naturally complement US goals. But for this to happen, the budding Indian entrepreneurial spirit must be encouraged to flourish and develop a deep and synergetic relationship with the American business community. Though India has made great strides in unleashing its entrepreneurial energy and boosting trade with the United States, its success on either front is by no means guaranteed.

Indeed, recent setbacks to the Indian economy, including a plummeting rupee and a policy agenda driven by populism rather than reform, raises questions about India's development trajectory that ought to concern policymakers in both Washington and New Delhi.³⁹

Recommendations for the United States

Services Trade. *Amend the comprehensive immigration reform bill to address the concerns of Indian information technology firms.*

From New Delhi's perspective, US visa policies are potentially the biggest irritant in the US–India economic relationship. India views provisions regarding skilled workers in the comprehensive immigration bill passed by the Senate in June as a direct threat to its thriving information technology industry.⁴⁰ And Indian entrepreneurs and businesspeople across industries rank uncertainty about visas as the single biggest impediment to closer business ties with the United States.⁴¹

The \$100 billion IT industry, which spans business process outsourcing (BPO), software, and outsourcing services, is the poster child of India's embrace of globalization.⁴² Arguably, this embrace can be dated from the 1999 NASDAQ listing of flagship IT company Infosys Technologies. Indian IT firms employ 2.8 million people in India and nearly 50,000 US citizens in America.⁴³ The industry is also the part of the Indian economy most deeply integrated with the US—Indian firms earn a bulk of their revenues here.⁴⁴ Over the past decade or so, Indian IT firms have also claimed a 10 percent share of the \$90 billion global outsourcing industry.⁴⁵

The crux of the issue lies in the treatment of firms that use a large number of H-1B temporary skilled worker visas and L-1 intracompany transfer visas. In 2010, the US Congress ratcheted up visa fees for

companies employing 50 or more workers if more than 50 percent of them used such visas.⁴⁶ In India this is widely viewed as targeting Indian IT firms whose employees typically perform such tasks as IT support, software programming, payroll processing, and data analysis for US clients.⁴⁷

But the industry's deeper concern regards provisions of the comprehensive immigration reform bill passed by the Senate in June. The bill mandates that by 2016 only 50 percent of a company's US workforce will be allowed to hold a temporary visa.⁴⁸ Until then, it recommends that firms that breach this arbitrary cap must pay the government a fee of up to \$15,000 for each additional temporary foreign worker they hire. For other firms, the same visa would cost \$5,000.⁴⁹

The proposed law also prohibits a skilled temporary worker from operating as an on-site contractor if more than 15 percent of his or her firm's US workforce holds an H-1B or L-1 visa.⁵⁰ On-site contracting—mostly various IT support and programming roles—often accounts for 50 percent of an Indian IT firm's revenues. Firms that seek permanent residency for at least 90 percent of their US-based employees on short-term skilled worker visas are exempted from this provision—but no major Indian firm comes close to meeting this threshold.

To be sure, an aspect of Indian criticism of US immigration reform misses the forest for the trees. All in all, the bill will bring more Indian technology workers to the United States by raising the number of H-1B visas from the current 65,000 to 110,000, expandable to 180,000, depending on demand. Indians will also benefit from an additional 25,000 H-1B visas for workers with advanced STEM (science, technology, engineering, and math) degrees from US universities and the removal of caps on the number of green cards that can be issued to them. Finally, the introduction of 10,000 new entrepreneur visas and 250,000 so-called merit visas will also likely bring more educated Indians to the United States and deepen links between the US and Indian economies.

But while expanding the number of visas available for highly skilled workers is good for India, the United States, and the US–India relationship, the same cannot be said for the current bill's arbitrary restrictions on which firms can benefit from these new visas. At present, 5 of the top 10 firms that use H-1B visas are Indian

(Infosys Technologies, Tata, Wipro, HCL, and Mahindra), and a sixth (New Jersey–based Cognizant Technologies) is founded by an Indian and equally reliant on the same visas.⁵¹ The new law will effectively tilt the playing field against these firms and toward US competitors such as IBM and Accenture, which also employ thousands of H-1B workers, albeit fewer as a proportion of their total workforce. It will also narrow choices for US firms that rely on outsourcing specialized tasks to boost efficiency.

Instead of the economic component of the US–India relationship taking a backseat to the strategic component, it ought to be the other way around.

The proposed restrictions on skilled worker visas would perhaps make more sense from an immigration perspective if they were designed to protect American jobs. But as the expanded H-1B caps implicitly acknowledge, Indian firms have thrived not merely because they can hire workers more cheaply but because they address a genuine market need. Last year the 65,000 cap on H-1B visas was used up within a week.⁵² Microsoft estimates that US colleges will produce only about 51,000 computer science graduates this year, whereas the Bureau of Labor Statistics says the United States will create 120,000 new jobs for people with degrees in computer science.⁵³

In sum, Indian IT firms increase the efficiency of the US economy, employ both Indian and US nationals, and deepen economic and people-to-people ties with India. Within India, the IT industry stands for the benefits of globalization and a free enterprise system that rewards skills and hard work in contrast to the cronyism that afflicts parts of the Indian economy. In this context, rules that tilt the playing field against arguably India's most competitive globalized industry, with no measurable benefit to the US economy, ought to be rejected.

Liquefied Natural Gas Exports. *Liberalize LNG export guidelines to allow exports to India (and other non-FTA countries) on a routine rather than case-by-case basis.*

Ending restrictions on LNG exports offers a way for the United States to underscore its traditional support for free markets, boost its own economy, and lessen India's energy dependence on Middle Eastern countries such as Iran.

The American shale gas boom, prompted by technological improvements in horizontal drilling and hydraulic fracturing, can help foster growth at home as well as deepen US–India economic linkages and encourage strategic confluence.⁵⁴ According to the US Energy Information Administration (EIA), total “wet” natural gas discoveries in 2011 represented the ninth consecutive annual increase and the highest volume of discoveries since the EIA began publishing proved reserves estimates in 1977.⁵⁵ The United States currently houses an estimated 2,203 Tcf (trillion cubic feet) in recoverable natural gas resources, or enough for 92 years at current consumption levels.⁵⁶

This unexpected bounty has reopened a dormant question. Should the United States export natural gas, and if so, to whom? The Natural Gas Act of 1938 requires that all exports and imports of natural gas be approved if the Department of Energy (DOE) determines that they promote the public interest.⁵⁷ Since 1992, the United States has not required the DOE to sign off on countries with which the United States has a free trade agreement, but it still reviews each deal with non-FTA countries such as India. As of the end of September 2013, DOE approved four LNG terminals to export to non-FTA countries, and at least 19 other cases were pending.⁵⁸ India has contracted gas or shown a likelihood of doing so from three out of the four fully or conditionally approved projects.⁵⁹

A freer US LNG export regime—one that does not require piecemeal approvals by the DOE—will add a new dimension to US–India economic relations and positively impact Asia by hastening the emergence of the United States as an important player in its burgeoning energy markets. But the case for exports to India is embedded in a broader principle the United States has long espoused—free energy markets. The argument that the DOE review should be kept in place to offer the United States leverage is shortsighted. It makes more sense to strengthen relationships by deepening commercial ties while upholding an important principle than to use potential government obstructionism as a bargaining chip.

Nor, as naysayers claim, is there a visible downside to freer US gas exports. Reserves are too vast to worry about them dwindling in the foreseeable future. A widely cited study commissioned by the DOE found that under all projected scenarios LNG exports created a net economic benefit for the United States, that the benefit increased as the volume of exports went up, and that unlimited export scenarios always outperformed those with limited exports.⁶⁰ In addition, the sheer size of its reserves gives the United States the ability to (at least marginally) lower prices worldwide, benefiting all importers, including India.

Locking in future gas exports to India early makes sense for several reasons. India is currently the sixth-largest importer of LNG in the world and will likely become one of the biggest LNG markets.⁶¹ According to energy consulting firm PFC Energy, until 2045 annual demand in India and Vietnam will grow faster (5 percent) than in any other country in the Asia-Pacific region.⁶² India already imports 75 percent of its energy needs, and this is expected to rise to 90 percent by 2023.⁶³ But rather than laying a broad foundation for future exports to India and other non-FTA countries, the US government continues to evaluate each case for its potential harm to the public good.

The DOE has approved exports by Texas-headquartered Cheniere Energy to India's state-owned Gas Authority of India Limited (GAIL) from the Sabine Pass LNG terminal in Louisiana.⁶⁴ Under the \$15 billion deal, Cheniere will export 3.4 tons of LNG annually to India for 20 years starting in 2017.⁶⁵ The DOE has also conditionally approved a deal between United LNG of Houston and India's Petronet for 4 million tons annually, and in September Dominion Energy received DOE approval for an additional 2.3 million tons annual export to GAIL.⁶⁶ BP will also likely market some of its LNG supplies to India through Indian Gas Solutions, a joint venture between BP and India's Reliance Industries.⁶⁷

This clutch of deals underscores the importance of US gas for India. As the world's fourth-largest energy consumer, India sees competitively priced US gas as an attractive investment.⁶⁸ Sabine Pass LNG, for example, will cost India about 20 percent less than fuel from Qatari RasGas.⁶⁹ India already operates LNG terminals in Maharashtra, Gujarat, and Kerala, and it is building

new facilities in Andhra Pradesh, Tamil Nadu, and Odisha.⁷⁰ Moreover, Indian companies have already invested \$4 billion so far in US tight (difficult to drill) oil and shale gas. Reliance has three joint partnerships worth \$3.5 billion, and GAIL has one joint partnership worth \$100 million in US shale plays.⁷¹ Dispelling any doubts about future approvals will encourage them to invest more.

Diversifying its energy sources also puts India in a better bargaining position with other energy suppliers and makes it less dependent on the volatile Middle East, enabling both India and the United States to devote more time and resources to strengthening economic ties in East Asia.

Finally, providing an alternate source of fuel will give Washington greater leverage as it seeks to encourage India to continue shrinking its dependence on oil from countries like Iran. More robust US–India economic cooperation—a byproduct of growing energy linkages—will reinforce the economic base for future ties.

Asia-Pacific Economic Cooperation. *Back India for full membership in APEC as a step toward eventual inclusion in the Trans-Pacific Partnership.*

Founded in 1989, the 21-nation APEC is East Asia's broadest economic grouping and the world's largest trading bloc, accounting for three billion consumers and 44 percent of global trade.⁷² In 2010, a decade-long moratorium on new members expired, opening the door for India, whose initial application for membership in 1991 was rejected. With Indonesia taking the group's helm this October in Bali, this is a particularly propitious time for expanding APEC. (Next year, China will take over leadership from Indonesia.)

Publicly backing India's candidacy for APEC membership would echo a broad US policy that supports India's rise as a responsible global power.⁷³ Washington has already supported Indian membership in the G-20, four multilateral nonproliferation regimes, and an expanded United Nations Security Council. In addition, India is already a full member of the East Asian Summit and the ASEAN Regional Forum and is a dialogue partner with ASEAN. As part of a "look east" policy begun in the 1990s, India has signed trade agreements with Japan, Korea, Singapore, Malaysia, Thailand, and ASEAN.

The case against backing India's entry into APEC hinges on its notoriously obstreperous trade negotiators, who some of their American counterparts hold responsible for helping create a stalemate at the World Trade Organization. Will admitting India into APEC hurt the group's capacity for consensus building and dilute the quality of trade agreements?

From New Delhi's perspective, US visa policies are potentially the biggest irritant in the US–India economic relationship.

Although these concerns are legitimate, backing India's APEC membership is a low-risk gambit for the United States and carries potentially large rewards. At worst, India complicates the workings of an already unwieldy body that concludes nonbinding agreements among members. At best, India uses APEC membership as training wheels to prepare it for the more ambitious Trans-Pacific Partnership (TPP), embraces the best practices APEC espouses, and invigorates the grouping with new energy.

Aspects of APEC make it especially appropriate as a venue for better aligning India's trade and economic policies with other market-based economies. To begin with, all members must sign up, at least formally, for the group's mission: "To champion free and open trade and investment."⁷⁴ India has a good record of keeping its international pledges. (For instance, it refused to sign the nuclear nonproliferation treaty instead of signing it and cheating like Iran and North Korea.)

Recent US experience at the International Atomic Energy Agency (IAEA), where India has voted with the United States at least four times against Iran since 2005, and at the United Nations Human Rights Council, where India and the United States both criticized Sri Lanka's human rights record, has shown that New Delhi is more interested in upholding existing norms than rewriting them. Despite more complicated domestic politics when it comes to economic issues, should India join APEC it can be expected to broadly uphold its goals.

Moreover, a multilateral organization provides both the United States and India with a less contentious

forum in which to engage each other regularly on economic issues. APEC's emphasis on information exchange on economic regulations and rules and procedures ought to have a beneficial impact on India's economic bureaucrats. Entrepreneurship will likely get a boost from APEC's coordination among private companies. The APEC Business Advisory Council, which consists of three business representatives from each APEC member economy, gives private businesses a formal role in the forum. Moreover, the kinds of specifics the grouping often champions, say a 10 percent improvement in supply chain performance, or 5 percent off tariffs on a list of environmental products, will give economic liberalizers within India's system extra ammunition for their cause.

Finally, most APEC economies offer entrepreneurs friendlier business environments than India. Indeed, the grouping includes several countries that are models for using free enterprise to spur development. In terms of ease of doing business, the World Bank ranks South Korea at number 8, Thailand at 18, and Chile at 37. (India stands at a dismal 132.)⁷⁵

In sum, the more India learns from the experiences of traditional US economic partners, the easier it will be for the United States and India to step up economic cooperation with the ultimate goal of including India in the TPP. (At present, India will not come even close to meeting the TPP goal of a high-quality agreement with few exemptions.) The United States should take the initiative and bring India on board APEC at the earliest opportunity.

Focus on States. *Recognize a trend toward greater federalism in the Indian economy and deepen relations with the fastest industrializing states.*

As India grows richer and more urban, it is also growing more federal. Both the US government and business should seize the opportunity to focus on India's most entrepreneurial states on the western and southern coasts. The successful US experience with federalism, and in building some of the world's greatest cities from scratch, can be particularly helpful to India's fastest-urbanizing states.

Moreover, the Indian-American diaspora, disproportionately drawn from economically dynamic regions such as Gujarat and Andhra Pradesh, offers a natural

bridge toward closer subnational business ties. Reliable estimates are difficult to come by, but on the high side some suggest that about half of Indian-Americans trace their origin to Gujarat.⁷⁶ At some point, the United States will need to take a cue from its allies and step up engagement with arguably India's most economically dynamic state.⁷⁷

Greater focus on states and cities makes sense for several reasons. As Morgan Stanley's Ruchir Sharma puts it, after a long period of highly centralized rule, India "is rediscovering its natural fabric as a nation of strong regions."⁷⁸ In political terms, this means powerful state-level satraps will exert greater influence in New Delhi and carve out more decision-making power for the country's 28 states, many of which are more populous than most countries.⁷⁹

A more federal and urban India will almost certainly display greater entrepreneurial dynamism and produce greater prosperity for more people faster. High-performing states also offer India the best chance to reform a populist political culture that hurts its economic prospects. If India embraces a reformist path more fully, it will be in part because ambitious state-level leaders such as Odisha's Naveen Patnaik and Gujarat's Narendra Modi have shown their peers that a business-friendly politician can win elections.

Although India as a whole is becoming more federal, from an economic perspective some states look more promising than others. The most promising are the National Capital Region (Delhi and the suburbs of Gurgaon and NOIDA), Gujarat, Maharashtra, Karnataka, Tamil Nadu, and Andhra Pradesh. Together, they account for one-third of the country's 1.2 billion people, but nearly half of India's \$4 trillion (in purchasing power parity terms) GDP. They also account for 8 of India's 10 most populous cities. Among them, these six states have maintained an average growth rate of 7.5 percent since 1991, compared with the national average of 6.2 percent.⁸⁰

For the foreseeable future, India's center of economic gravity will remain in the south and west. In terms of growth rates, some of the poorer states of northern and eastern India such as Bihar, Uttarakhand, and Odisha have begun to catch up—and in some cases overtake—these six economically dominant states. But this development, though entirely welcome, largely reflects an

extremely low base. In 2012, per capita income in Maharashtra was estimated at about 100,000 rupees; in Bihar it was about a quarter of that.⁸¹ Moreover, the poorer states are also slower to urbanize.

Of the six leading states, one (Delhi) is already a city-state. The consulting firm McKinsey and Company predicts that by 2030, Gujarat, Maharashtra, Tamil Nadu, and Karnataka will all have urban majorities.⁸² Though the most successful international firms target both rural and urban Indians, the simple fact remains that richer consumers are the most natural market for many American products and services ranging from cars to software to smartphones to college degrees.⁸³ It is not a coincidence that cities such as Mumbai (finance and entertainment), Bangalore and Hyderabad (technology and outsourcing), Delhi (services), and Pune and Ahmedabad (manufacturing) have produced India's most successful entrepreneurs in the postliberalization era.

To an extent, the United States is already responding to changes underway in India. When President Jimmy Carter visited India in 1978, he ventured no farther than a village on the outskirts of Delhi. By contrast, Presidents Clinton and Bush both included Hyderabad on their itineraries, and President Obama spent a day in Mumbai in 2010. Since then, former secretary of state Hillary Clinton laid out a vision for greater Asian connectivity in Chennai (Madras) and spoke in Kolkata (Calcutta) of the city as India's "Gateway to the East."⁸⁴ The State Department has set up an Office of Global Intergovernmental Affairs to serve as "a bridge between US state and local elected leaders and their subnational counterparts abroad."⁸⁵

Meanwhile, in the past year alone, Maryland governor Martin O'Malley, Washington State governor Christine Gregoire, and San Antonio mayor Julian Castro have led trade missions to India. The United States has opened 12 "American Business Corners" across the country. Their goal is "facilitating economic engagement with India's booming urban centers and strengthening US-India business connections by providing Indian entrepreneurs information about trade and investment opportunities with the United States."⁸⁶

But while these initiatives are well intentioned, they could benefit from more focus. Simply put, the United States should resist the urge of spreading itself too thin

across India and instead focus its limited resources on the most economically promising parts of the country. This means that at some point, stepped-up engagement with Gujarat is unavoidable.

Gujarat is the closest thing to a slice of East Asia—say Japan in the 1960s or South Korea in the 1980s—set amid the dust and drama of the Indian subcontinent.⁸⁷ For a decade, the state on the edge of the Arabian Sea has averaged double-digit growth rates, the only large Indian state to do so. With only 5 percent of India's 1.2 billion people, Gujarat accounts for almost one-third of the country's stock-market capitalization, more than one-fifth of its exports, and about one-sixth of its industrial production.⁸⁸ Per capita electricity consumption in the state is about twice the national average.⁸⁹

Backing India's APEC membership is a low-risk gambit for the United States and carries potentially large rewards.

Should it decide to open a fifth consulate in India—to match India's five consulates in the United States—Gandhinagar/Ahmedabad is the most logical location. The United States already has two consulates (Chennai and Hyderabad) in the South, but only one (Mumbai) in the equally dynamic West.⁹⁰ Any expansion should also factor in the presence of a large Gujarati diaspora in the United States, estimated to be at least 1 million people.⁹¹

Over the past year, ambassadors from the European Union, the United Kingdom, and Australia have all met with Chief Minister Modi.⁹² But, thanks to anti-Muslim riots in 2002 on his watch that killed more than 1,000 people, about three-fourths of them Muslim, the United States continues to avoid engaging with him at the ambassadorial level.⁹³ Nor has any cabinet-level official visited Gujarat in over a decade. Business, though, has not been squeamish. US-India Business Council president Ron Somers regularly participates in the state's flagship "Vibrant Gujarat" investor summit. Ford Motor Company, Abbott Motors, and MeadWestvaco are among the American firms that have invested in the state or are in the process of investing in it.

High-level engagement need not be construed as an endorsement of Modi's prime ministerial ambitions. Indeed, a case can be made for postponing such an engagement until after India's 2014 general elections. But stepped-up ties with Gujarat will correct an anomaly in current US economic policy and ought to be an essential element of a broader focus on fast-growing states that offer the brightest commercial prospects for America.

For US firms, a high-quality BIT with India will add a layer of security and certainty.

Bilateral Investment Treaty. *Negotiate a high-quality BIT as a stepping stone toward a free trade agreement.*

A US–India BIT will signal renewed purpose in economic relations between the two countries, level the playing field for US firms in India, and pave the way for a more ambitious free trade agreement.

A BIT with India was first proposed by the George W. Bush administration, but progress on it has long languished in both countries.⁹⁴ The United States only completed a three-year review of its model BIT in 2012, and India is in the midst of a review of its own model BIT. In theory, Washington and New Delhi both support the idea of a US–India investment treaty. In practice, progress toward this has been virtually nonexistent.

Less comprehensive than a free trade agreement, a BIT nonetheless facilitates foreign investment by ensuring so-called national treatment of foreign firms, limiting government expropriation, and providing for binding arbitration between investors and governments.⁹⁵ Currently, the United States has operational BITs with over 40 countries, including Bangladesh and Sri Lanka in South Asia. India has a BIT or some kind of trade-and-investment treaty with 82 countries, including US allies Israel, the United Kingdom, Japan, and Germany.⁹⁶ The lower number of US BITs reflects an American preference for comprehensive trade deals rather than more limited investment treaties.

Some supporters of the US–India relationship regard a BIT as trivial, given the size of the US and Indian economies and the scale of ambition a “strategic partnership” between the two countries suggests.⁹⁷

Nonetheless, negotiating one is a good idea, not as an end in itself, but as a significant marker toward the broader—but at this point politically unfeasible—goal of an FTA. A BIT will not in itself transform the trade relationship between the United States and India, but the inability to negotiate one raises legitimate questions about both countries' commitment to making meaningful progress on trade.

For US firms, a high-quality BIT with India will add a layer of security and certainty. Even though the investment climate in India has deteriorated over the past 18 months, it remains the world's largest untapped market, one where American firms have a chance to establish a strong presence in many industries before consolidation makes it harder to claim market share from well-established rivals.⁹⁸ At the moment, the United States channels some of its FDI to India through Mauritius and Singapore not merely for tax reasons but also because these investments attract some of the added protection that comes with a BIT.⁹⁹ Matthew Stokes, a State Department official who has studied the potential for a US–India BIT in detail, expects infrastructure, services, and retail firms, in particular, to get a boost.¹⁰⁰

Moreover, lining up political support for an investment treaty is much easier than doing the same for an FTA. A BIT only needs to be approved by two-thirds of the US Senate.¹⁰¹ The often more protectionist House of Representatives does not need to weigh in. Two years ago, 10 senators from the India Caucus wrote a letter to President Obama recommending the resumption of BIT negotiations with India.¹⁰² The president himself has indicated his support for the idea in an interview.¹⁰³ Senator John McCain has also stated his support for BITs with India and Taiwan.¹⁰⁴

Of course, broad political support for the idea will not necessarily lead to a successful negotiation. For the United States, long the world's leading exponent of free markets, its BIT represents the standard to which others should aspire. For its part, India has come to expect treaties tailored to its circumstances. Moreover, by adding tougher labor and environmental standards, the new model US BIT has likely made reaching an agreement with a developing country such as India more difficult. Then there is the knotty matter of short-term skilled workers. Traditionally, the United States does not discuss visa-related issues in trade negotiations, but

for India, market access for its highly competitive information technology industry is a priority.¹⁰⁵

Nonetheless, if both sides are committed to a deeper economic relationship they need to work to overcome potential obstacles. The United States should not aim for an agreement for the sake of an agreement, but seek a high-quality BIT that includes independent arbitration and strong protections for investors. But nor should it avoid pursuing a BIT as not worth the effort. Should the United States fail to make progress here, it may find itself disadvantaged as India presses ahead on agreements with competitors. It will also serve as a sobering reality check on the limits of the broader US–India relationship.

Recommendations for India

Bilateral Investment Treaty. *Negotiate a high-quality BIT as a stepping stone toward a free trade agreement.*

For India, a BIT would boost foreign investor confidence, arrest the drift in US–India economic relations, and protect Indian firms in America.

With the Indian economy losing much of its sheen over the past two years, negotiating a BIT would signal fresh purpose and momentum to both American and international investors. As in America, top policymakers in India have already expressed support for the idea in principle. Among those who have broached the topic of starting talks are Finance Minister Palaniappan Chidambaram, Commerce Minister Anand Sharma, and Planning Commission Deputy Chairman Montek Singh Ahluwalia.¹⁰⁶

Though there is little realistic chance of negotiating a BIT before India's general elections in 2014, a bold statement, including a willingness to consider binding investor-state arbitration and offer protection for “pre-establishment” investments, would signal to businesspeople that India has returned to the path of reform and openness after a long bout of unrestrained populism, policy paralysis, and antibusiness actions such as the 2012 imposition of retroactive taxes on telecom company Vodafone. Taking this forward could then be among the first acts of a new government in New Delhi.

The advantages to India of a BIT with the United States are self-evident.¹⁰⁷ This kind of treaty is designed

to facilitate flows of foreign direct investment. In infrastructure alone, the Indian government estimates a need of \$1 trillion in the five years to 2017, at least half of which it seeks from overseas.¹⁰⁸ An added layer of protection for US firms will also likely boost the already thriving services trade between the two countries. India also needs foreign investment to plug its gaping current account deficit (\$88 billion or 4.8 percent of GDP) and stabilize its plummeting currency.¹⁰⁹ The rupee has lost 20 percent against the dollar in the first eight months of 2013.¹¹⁰

Finally, Indian firms increasingly investing in the United States—especially in steel, chemicals, and information technology—would gain the same benefit as their American counterparts in India.¹¹¹ To be sure, the United States is a much more open economy, with far fewer restrictions on foreign business, than India. But a BIT will nonetheless act as an insurance policy against stray protectionist impulses that arise in America from time to time, especially at the state level.¹¹²

To attract the most FDI, however, India will have to approach a BIT with the United States not merely as one of scores of trade deals, most of which are riddled with exceptions and relatively lax regulations.¹¹³ To send the message that India is open to US business—and by extension, to the world's—it must negotiate a high-quality BIT. To begin with, this requires accepting the essential principle of binding international arbitration in third-party courts rather than insisting on domestic jurisdiction.

Given inordinate delays and policy flip-flops in India over the past several years, the US practice of extending protections to preestablishment investments—to guard against discrimination even before an investment is made—should also be part of any credible BIT. Similarly, complex export obligations and technology transfer rules interfere with the free flow of investment. Overall, India's approach should be determined by a broad understanding that large FDI flows are overwhelmingly beneficial to the economy rather than by a narrower vision that ends up driving away many potential investors with unrealistic preemptive demands.

In sum, both the United States and India need to advance quickly toward a BIT. An inability to pursue even this relatively modest goal casts a shadow on the prospect of deeper US–India economic ties,

longer-term goals such as including India in the TPP, and, by extension, a deeper strategic partnership itself.

Intellectual Property Rights. *Encourage innovation by increasing the protection of intellectual property rights in line with global norms.*

In some ways, India's intellectual property rights (IPR) regime mirrors its economy more broadly. Compared with the preliberalization era—when India refused to recognize product patents—the country has taken great strides toward accepting global laws, norms, and practices.¹¹⁴ At the same time, India's IPR regime remains an international outlier, and a flurry of government decisions and court rulings suggest that India is backsliding rather than advancing in terms of protecting IPR.

For US–India relations, India's IPR regime has the potential to flare into an intractable problem. The US Chamber of Commerce's Global Intellectual Property Center ranks India last among 11 countries in terms of overall protection of intellectual property.¹¹⁵ For the Office of the US Trade Representative (USTR), India remains on a “priority watch list,” along with 10 other countries, including China, Russia, and Pakistan.¹¹⁶ The USTR's *2013 Special 301 Report* says that, “there are serious questions regarding the future condition of the innovation climate in India across multiple sectors and disciplines.”¹¹⁷

This year alone, the issue has been raised by, among others, Vice President Joe Biden, Secretary of State John F. Kerry, Senators Max Baucus and Orrin Hatch, and members of the House of Representatives Energy and Commerce Committee.

India argues that it provides IPR protection in accordance with its obligations under the World Trade Organization's agreement on Trade Related Aspects of Intellectual Property Rights (TRIPS).¹¹⁸ And indeed, New Delhi has amended its patent laws three times since 1999 to enhance IPR protection, most recently in 2005. Nonetheless, global pharmaceutical firms share a virtually unanimous view that intellectual property lacks sufficient protection in India and that since last year the country has shown signs of sharp backsliding.¹¹⁹

Western firms that have had their IPR claims overturned in India include Novartis, Bayer, and Roche and the American firms Gilead, Pfizer, and Merck.

In March 2013, an Indian court in Chennai upheld a government decision to evoke compulsory licensing on Bayer's anticancer drug Nexavar. The ruling allows an Indian firm to sell the drug for about one-thirtieth the price charged by Bayer (\$160 instead of \$5,181) and pay Bayer a flat royalty rate of 7 percent.¹²⁰

In April 2013, the Indian Supreme Court rejected a patent on another widely patented anticancer drug, Novartis's Glivec. The court ruled that Glivec was not demonstrably more effective than a predecessor, even though the company had argued that Glivec is 30 percent easier for the body to absorb.¹²¹ In August an Indian parliamentary committee examining FDI in pharmaceuticals suggested a blanket ban on foreigners purchasing brown field (existing) projects. The committee also bluntly defended compulsory licensing: “The availability of patented drug to the needy is more important than the interest of the patent holder.”¹²²

Though neither Bayer nor Novartis are American firms, the US pharmaceuticals industry widely supports their view on both compulsory licensing and patentability.¹²³ Critics say India's patent law (2005) is too stringent because it mandates that patents for new forms of known substances should be rejected when the new form “does not result in the enhancement of the known efficacy of that substance.”¹²⁴

Although ostensibly meant to prevent pharmaceutical firms from “ever greening” patents, or extending their validity through small tweaks, this clause effectively allows Indian firms to sandbag multinationals. For instance, in 2009 an Indian court rejected California-based Gilead Sciences' patent for the blockbuster anti-AIDS drug Viread.¹²⁵ Given that developing a new drug can cost as much as \$1 billion, a lax patent regime will force global pharmaceutical firms to think twice before investing in India.¹²⁶

A detailed discussion of India's patent laws—or the pros and cons of individual cases—is beyond the scope of this report. Suffice it to say that though India's IPR regime may be legal, that does not make it desirable. For IPR to become a source of cooperation rather than conflict between India and the United States, India needs to frame the issue in terms of creating conditions to attract more international investment and expertise rather than as a crude face-off between rich and poor countries.

An IPR regime more in line with global norms will allow India—with its vast pool of trained scientists in both India and the West—to emerge as a hub for cutting-edge research rather than mostly a manufacturing center for cut-rate off-patent drugs. To begin with, India should consider reexamining section 3(d) in its patent act, which contains the problematic language about enhanced efficacy.¹²⁷ Fast-track IPR courts will address another frequent concern—endless delays that effectively allow patent breakers to profit while a case winds its way through the courts. Instead of using blunt instruments like compulsory licensing and patent revocation, India can work with innovative American firms to improve access for those who cannot afford expensive medicines.

To sum up, it is unrealistic, and possibly even undesirable, to expect Indian courts to always decide cases in favor of multinational firms.¹²⁸ But it remains in India's interest—in both economic and diplomatic terms—to establish an IPR regime that is converging toward global standards rather than backsliding toward intellectual protectionism and regulatory capture by powerful local firms.

Preferential Market Access. *Allay investor concerns about draconian local content requirements for technology purchases by unambiguously scrapping the suspended preferential market access (PMA) policy.*

India's goal of boosting domestic manufacturing capacity in information and communications technology (ICT) is laudable. But forced localization requirements represent a throwback to a preliberalization command-and-control mentality. Instead of effectively ordering firms to manufacture in India, the government should work to overcome the many bottlenecks that stop foreign investors from setting up more factories in the country. US–India Business Council president Ron Somers suggests that manufacturing in India should be incentivized on market-based principles.¹²⁹

With its vast market, young and inexpensive labor force, large pool of engineers and scientists, and influential diaspora in Silicon Valley, India ought to be a magnet for US ICT firms such as Apple, Dell, and Oracle that are looking to diversify their manufacturing base. That most of these firms flock to China or Southeast Asia instead suggests a problem in India that

cannot be fixed simply by government fiat.¹³⁰

India's controversial PMA program dates to February 2012, when it announced a policy to impose local content requirements on both government and private procurement of electronic products with “security implications” for the country.¹³¹ The government listed 23 telecom products and 6 electronics or information technology–related products that would attract domestic preferences. The local content share in these projects was to range from 30 percent to 100 percent, rising over time.¹³²

India can only hope to undo the damage done to its reputation by reversing its amendment on retroactive taxation and putting in place a fair, transparent, and predictable tax policy.

The broader goals of India's PMA policy include a target of 80 percent of computers and electronics sold in India by 2020 to be locally manufactured, and a thirteenfold increase in India's ICT exports to \$80 billion by 2020.¹³³ Similarly, in clean energy, India has slapped local content requirements on wind turbines and solar panel components.¹³⁴ In February of this year, the United States requested a World Trade Organization settlement over India's solar program.

Amid an international furor, including congressional hearings in March and June of this year and letters to President Obama from over 200 members of Congress expressing concerns about “discriminatory practices” and “barriers that hurt US exporters, investors and workers,” New Delhi partially suspended PMA in July.¹³⁵ But the policy has been only held in abeyance, not entirely ended.

On the face of it, the underlying policy goals driving PMA are unobjectionable. India hopes to bolster manufacturing, generate employment, and reduce a yawning current account deficit.¹³⁶ But as Stephen Ezell of the Information Technology and Innovation Foundation points out, about 80 percent of the economic benefits of technology lie in its use and only 20 percent in its production.¹³⁷

Moreover, India hardly houses a domestic technology manufacturing base to speak of. HCL and Tejas Networks are among the few firms with such a capacity. Quite simply, harsh local content requirements would slow down the Indian economy by hurting productivity across the board.

To revive Indian manufacturing, India needs to focus on the basics—speedy and sensible land acquisition, labor laws that do not discourage firms from hiring, world-class infrastructure, and at least a modicum of good governance. Not one of the entrepreneurs interviewed for this report—including up-and-coming software product manufacturers in Silicon Valley, Bangalore, and Hyderabad—said they required government-imposed quotas to be competitive.

Against this backdrop, India should publicly disavow PMA as a wrong turn taken at about the same time as the similarly destructive retroactive tax law.

Taxation Policy. *Reject retroactive taxation and end aggressive collection based on unpredictable and sometimes indecipherable rules.*

No policy since the advent of liberalization has harmed India’s reputation with global investors more than last year’s legal amendment permitting taxation of overseas deals involving an Indian asset with retroactive effect for 50 years.¹³⁸ The law arose after India lost a \$2.2 billion tax claim against Vodafone in the Supreme Court over the telecom firm’s 2007 purchase of Hong Kong firm Hutchison Whampoa’s Indian operations.¹³⁹ The law has severely dented India’s reputation for rule of law, due process, and separation of powers.

But retroactivity is only one among a raft of taxation-related issues facing foreign businesses operating in India. For now the country has put off until 2016 the implementation of controversial new rules on tax avoidance (General Anti-Avoidance Rules) that businesses fear create uncertainty and place too much discretionary power in the hands of tax officials.¹⁴⁰ Suspicious that firms may label high-end products and services developed in India as routine work, and under pressure to up tax collection so as to bridge a budget deficit fueled by handouts and subsidies, tax authorities have aggressively targeted a raft of foreign firms.¹⁴¹

Firms currently (or recently) embroiled in tax disputes with India include Google, Microsoft, Yahoo,

Nokia, Royal Dutch Shell, Vodafone, LG Electronics, and Cadbury.¹⁴² Last year, Ernst and Young estimated that at least 1,500 transfer pricing disputes were being litigated in India as of 2011, compared with fewer than six such cases in the United States and none in Taiwan or Singapore.¹⁴³ Because about half of all transfer pricing claims involve information technology or business process outsourcing firms, India’s aggressive methods disproportionately affect the US–India relationship.¹⁴⁴

Nobody expects that every tax dispute between a multinational corporation and the government of India will be settled in the former’s favor. But the sheer volume of cases, and the fact that usually reticent firms are being forced to speak out publicly on this issue, indicates the seriousness of the problem. In August, Finnish telecom firm Nokia, fighting a \$311 million tax claim, threatened to quit India.¹⁴⁵ Shell India, accused of undervaluing shares transferred to its parent company by \$2.8 billion, has called the case against it “bad in law.”¹⁴⁶

This year alone, Vice President Joe Biden, Secretary of State John Kerry, and US Ambassador to India Nancy Powell have pointed out the tax problems US companies face in India. The US–India Business Council has implied that India’s transfer pricing policy is “a selective and arbitrary mechanism for raising revenues.”¹⁴⁷ India’s premier IT trade body, the National Association of Software and Service Companies (NASSCOM), calls the tax authorities’ approach toward transfer pricing “inconsistent and very aggressive.”¹⁴⁸

To its credit, under Finance Minister Chidambaram, India has responded to business concerns. It has postponed the implementation of General Anti-Avoidance Rules and increased the threshold limit for mandatory scrutiny of cross-border transactions to 15 crore rupees, or \$2.3 million. It has also changed transfer pricing rules related to research and development and proposed “safe harbor” rules to provide firms with greater certainty.¹⁴⁹ Nonetheless, so far India has failed to amend the retroactive tax law, though the government is in talks with Vodafone to reach an amicable settlement.

Though recent tweaks to taxation policy are encouraging, India can only hope to undo the damage done to its reputation by reversing its amendment on retroactive taxation and putting in place a fair, transparent, and predictable tax policy. Successful Asian economies

such as Singapore and Hong Kong boast extremely high tax compliance rates. They do not have a tax system so complex that even large firms that employ batteries of tax lawyers cannot be sure that they are compliant.

In 2012, India had a chance to showcase its respect for the rule of law by accepting the Supreme Court judgment in favor of Vodafone. It missed that opportunity, but it is not too late to make amends by simplifying and rationalizing taxation policy.

Civil Nuclear Commerce. *Create conditions that allow US firms to participate in India's nuclear industry.*

Eight years after the United States and India first signed a historic deal to end India's nuclear isolation, and five years after the US Congress ratified it and the multilateral Nuclear Suppliers Group granted India a waiver giving it access to nuclear technology and fuel from other countries, the United States has yet to sell a single nuclear reactor to India.¹⁵⁰ The September 27 announcement in Washington that India's state-owned Nuclear Power Corporation and Westinghouse have commenced commercial negotiations to build a reactor in Gujarat is a step in the right direction, but no guarantee of success.¹⁵¹

Arguably, the main political goals of the deal have been met. Washington has ended perhaps the single biggest source of mistrust toward it in New Delhi by ending India's exile from global nuclear commerce. India has separated its civilian and military reactors and brought eight additional (civilian) nuclear power plants under international safeguards.¹⁵² Though it had never proliferated to other countries despite not being a signatory to the 1968 Non-Proliferation Treaty, India is now more formally stitched into the global nuclear system as a responsible actor.

For India, the deal with the United States and the waiver from the Nuclear Suppliers Group that followed have been potentially transformative. New Delhi has subsequently signed nuclear agreements with Russia, France, and the United Kingdom, among others. Last year, the state-owned Nuclear Power Corporation announced that it will build 16 new reactors over the next five years at an estimated cost of 2.3 trillion rupees (\$40 billion).¹⁵³

The International Energy Agency estimates that India's 20 reactors produce only 4.8 gigawatts of power,

accounting for only 4 percent of India's total and ranking India 13th in the world in terms of power generation. The nuclear deal opens the door to the country's ambitious goal of quadrupling this capacity to 20 gigawatts by 2020.¹⁵⁴

Nonetheless, pointing out that the nuclear deal has so far failed to fulfill its promise in commercial terms would be an understatement. Indeed, for skeptics in Washington, it has become emblematic of the failure of US-India relations to live up to the rhetoric of nearly a decade ago.¹⁵⁵

Pointing out that the nuclear deal has so far failed to fulfill its promise in commercial terms would be an understatement.

The nub of the problem lies in legislation. In 2010, India's Parliament passed a nuclear liability law that deviates sharply from international practice by holding nuclear suppliers potentially liable in case of an accident.¹⁵⁶ (Liability usually rests with the operator.)

The liability law has made it harder for India to negotiate commercial nuclear deals with all countries. But it has also effectively tilted the field against United States and US-based firms such as GE-Hitachi and Westinghouse (now owned by Japan's Toshiba).¹⁵⁷ Unlike state-controlled French and Russian reactor vendors, private US firms cannot expect their liability to ultimately be borne by the government.¹⁵⁸ This could result in American firms being locked out of the Indian market despite the fact that the market itself would not exist if not for US efforts.

In a sense, India's liability law has come to symbolize a problematic aspect of India's political process—its impractical and often effectively antibusiness bent and a tendency to disregard widespread international practice. The public safety objectives of the law—heightened by the 1984 Bhopal gas tragedy—are by themselves unobjectionable. Nonetheless, the law will almost certainly end up hurting India's larger goals of creating a more balanced energy mix, reducing dependence on foreign fossil fuel supplies, and cutting carbon emissions.

Though the symbolic importance of American reactors helping address India's chronic power shortages

cannot be overstated, India should ask why firms balk at entering the Indian market. To fulfill its own energy goals, as well as the larger promise of the 2005 nuclear deal, India should consider either amending its liability

law or crafting implementing regulations that bring India in line with international practice. Otherwise, the deal will likely symbolize the failure of US–India economic relations to live up to their potential.

Part II: Renewing Reform in India

Overview

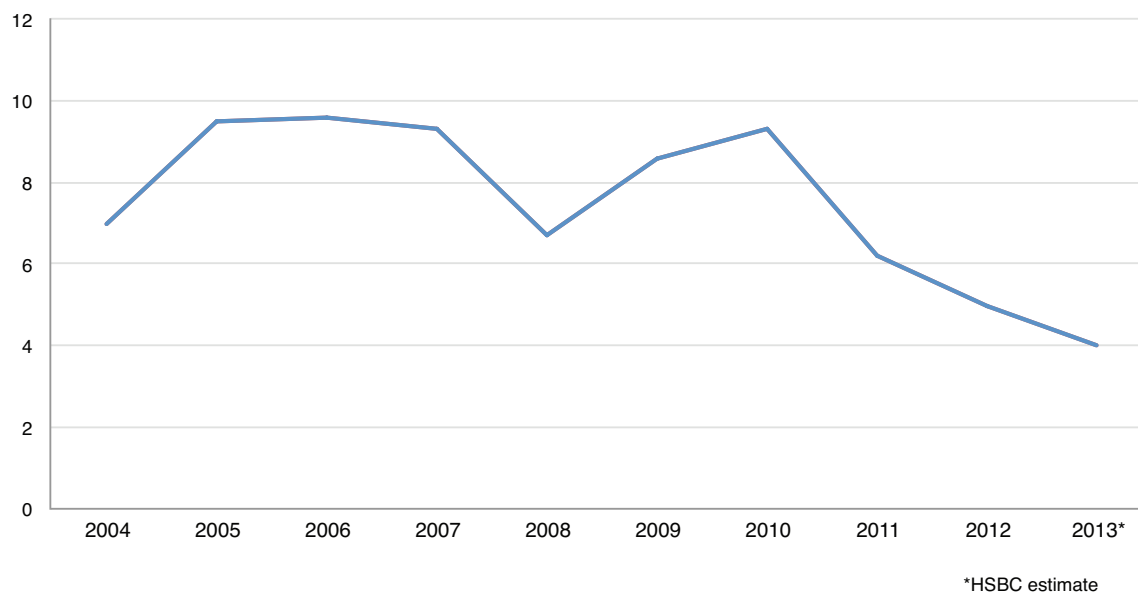
Over the past two years, India's economic prospects have begun to come into question. It can no longer call itself the world's fastest-growing democracy or the second-fastest-growing major economy after China.¹⁵⁹ Those titles, fleetingly held by India earlier this decade, have since passed to Ghana and Indonesia, respectively.

India's annual GDP growth has plummeted from 9.3 percent in 2010 to an estimated 4 percent in 2013 (figure 2). Moreover, compared to successful East Asian economies, India's slowdown has occurred at a low level of per capita income (\$3,340 in purchasing power parity terms). At a similar level of development, China, Japan, and South Korea had no trouble keeping

their foot on the gas pedal of high growth for decades. Despite its own slowdown, China continues to grow faster than India, though the average Chinese is almost 2.5 times richer than the average Indian.¹⁶⁰

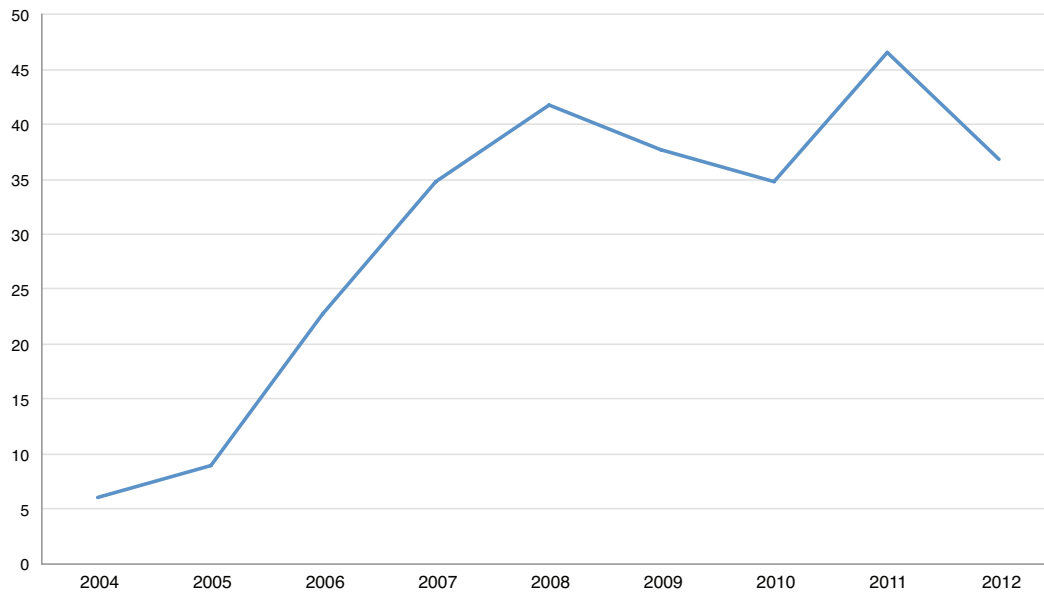
Although signals that the US Federal Reserve will "taper" its quantitative easing have affected many emerging country stock markets and currencies, India has been hit worse than most. Investors have disproportionately punished countries with poor fundamentals, such as large trade imbalances and foreign borrowings.¹⁶¹ The Indian rupee has declined 32 percent against the dollar since 2009 and 20 percent in 2013 alone. On August 28 this year, it briefly hit an all-time low of 68.8 to the dollar before staging a partial recovery.

FIGURE 2
ANNUAL GDP GROWTH (PERCENTAGE)



Source: Planning Commission, India

FIGURE 3
ANNUAL FDI FLOWS (\$ BILLION)



Source: Department of Industry and Policy Promotion, India

The economy's problems run beyond the volatility of currency and stock markets. After rising sharply over the past two decades, India's investment/GDP ratio—shorthand for the creation of productive assets—declined nearly 3 percent between 2007 and 2012, from 37.6 percent to 34.9 percent.¹⁶² Last year, foreign direct investment inflows to India fell about 20 percent to \$36 billion (figure 3). Meanwhile, a profligate government has allowed both fiscal and current account deficits to balloon. Between 2005 and 2012, the central fiscal deficit rose from 1,464 billion rupees to 5,209 billion rupees (\$80 billion at current exchange rates), or from 4 percent of GDP to 4.8 percent of GDP.¹⁶³ With imports outstripping exports, the current account deficit rose from 1.2 percent to 4.9 percent over the same period, or from 407 billion rupees to 5,268 billion rupees (\$88 billion at current exchange rates).¹⁶⁴

Indeed, the likelihood that FDI inflows to India will continue to decline this year remains high. In July, Korean steelmaker POSCO pulled out of a \$5.3 billion investment in Karnataka.¹⁶⁵ Two days later, Luxembourg-based ArcelorMittal announced its withdrawal from a \$12 billion steel project in Odisha.¹⁶⁶ Telecom manufacturer Nokia, which has invested \$285 million in its

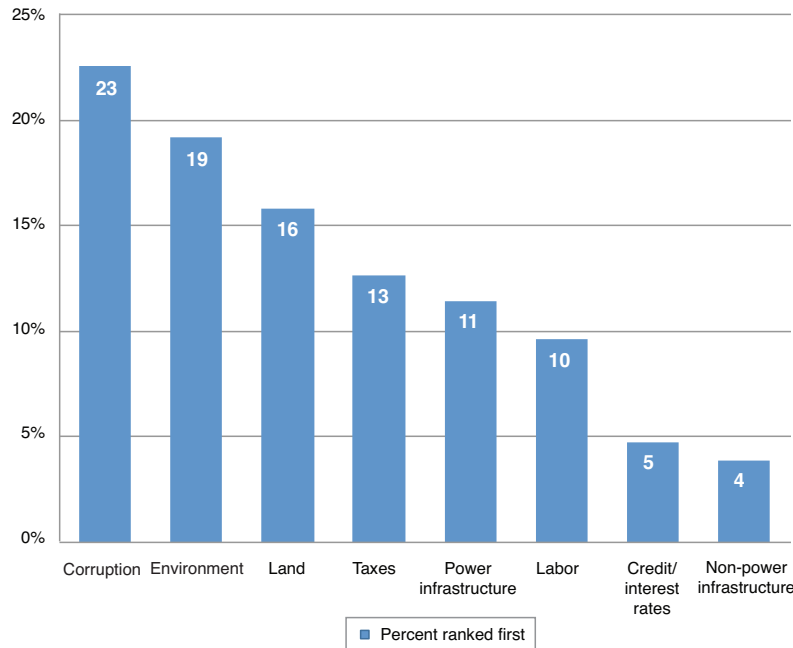
Tamil Nadu plant since 2006, has threatened to withdraw from the country over a protracted tax dispute.¹⁶⁷

Despite the slowdown, we find that Indian entrepreneurs and businesspeople, used to functioning under challenging conditions, remain broadly optimistic. But for India to pull itself out of the current slump, its political leadership will need to contemplate serious economic reform after next year's general election.

In particular, the government should smooth land acquisition for industry and infrastructure, create a unified market through a goods and services tax, improve the power supply, and upgrade its education system and rationalize labor laws to provide businesses with a well-trained and flexible workforce. In addition, businesspeople expressed strong concerns about corruption and excessive environmental regulation (figure 4), but these larger issues lend themselves less easily to well-defined policy solutions.

These recommendations are not new. Indeed, two decades after the advent of liberalization, India's need to find a sensible way to acquire land for development, rationalize tax collection through a goods and services tax, provide uninterrupted power supply in much of the country, and spur manufacturing by rationalizing

FIGURE 4
DESIRED REFORMS BY BUSINESSPEOPLE



Source: AEI/YouGov Survey

labor laws raises profound questions about the capacity of its political system to deliver reforms the economy needs. Nonetheless, a degree of consensus among leading economists and the businesspeople we surveyed reinforces the importance of these particular reforms.¹⁶⁸ Progress in these areas would arguably be the clearest way to demonstrate seriousness of intent to domestic and foreign investors alike.

Though external factors such as US “tapering” have contributed to India’s current predicament, it mostly has itself to blame. T. N. Ninan, one of the country’s foremost economic commentators, says the country’s political climate is “more hostile to business than at any time since the mid-1980s.”¹⁶⁹ Instead of streamlining regulations and encouraging investment, India effectively squandered its boom years of nearly double-digit growth by splurging on ineffective and unaffordable welfare schemes and throttling private industry in regulations redolent of the infamous license-permit raj.¹⁷⁰

India remains one of the world’s toughest big economies in which to do business. The Cato Institute ranks

India 111th of 144 countries in terms of economic freedom, lower than Haiti, Tunisia, and Swaziland.¹⁷¹ In the Heritage Foundation’s annual index of economic freedom, India ranks about two-thirds of the way down the list—119th of 177 countries. Nor has India managed to rise in the World Bank’s benchmark Ease of Doing Business index. In 2005, it ranked 134th of 175 nations. Seven years later it stood at 132nd of 185 countries.

Our survey finds that a poor business environment hurts new entrepreneurs disproportionately. Whereas 87 percent of entrepreneurs and senior executives in firms more than 25 years old—survivors from the socialist era—were broadly satisfied with current business conditions, only 58 percent of those in firms less than two years old felt the same way. This finding also reinforces a more widely held perception—that while some older, more established businesses have the know-how (and resources) to navigate a byzantine system, smaller entrepreneurs find it much more difficult.

That said, the decline in business conditions affects large and small alike. Last year, the usually reticent

Ratan Tata, outgoing head of the \$100 billion Tata Group, lashed out at India's "venal" business climate and suggested his group would pursue overseas opportunities instead of investing at home.¹⁷² Separately, he added that "if we had the same kind of encouragement to industry . . . I think India could compete definitely with China."¹⁷³ Kumar Mangalam Birla of the diversified Aditya Birla Group warned that India needs "to recognize the collective impact of delays and what impact it has on the image of the country as an investment destination."¹⁷⁴ "We are not optimistic, but we are opportunistic."¹⁷⁵ Against this backdrop, investments abroad by Indian business acquire dual meaning. They underscore the global ambition of Indian entrepreneurs, but they also suggest flagging confidence in India among those who know it best.

India remains one of the world's toughest big economies in which to do business.

Much of the problem lies in governance. Indian ruling elites continue to debate issues long settled in more advanced economies. In 1972, during the height of India's failed experiment with socialism, then prime minister Indira Gandhi lectured the Federation of Indian Chambers of Commerce and Industry: "Growthmanship which results in undivided attention to the maximization of GNP can be dangerous, for the results are almost always social and political unrest."¹⁷⁶

Nobody uses the word "growthmanship" anymore, but in India, unlike in China and much of East Asia, growth is still looked on with a tinge of suspicion. Indian politicians routinely use the phrase "inclusive growth," implying that growth itself is somehow suspect. Simply put, in India, not everyone has figured out that the roots of poverty lie in four decades of socialist overreach, not in two decades of half-hearted capitalism.

Continued ambivalence toward free enterprise and complacency about the future help explain a series of actions that have harmed India's image as an investment destination. Among them are last year's decision to impose retroactive taxes, government-mandated corporate social responsibility for private firms, overly broad taxation powers for officials, and extra taxes on the

wealthiest income taxpayers (thus increasing the burden on those who already pay their share, instead of seeking to widen an extremely narrow income tax base).

Meanwhile, over the past decade the Indian government has attempted what Morgan Stanley's Ruchir Sharma calls the "premature construction of a welfare state."¹⁷⁷ Its ambitious "rights based" model spans food subsidies for two-thirds of the population, a corruption-ridden \$6 billion make-work program that promises every rural Indian 100 days of employment, and a right-to-education law that effectively penalizes innovative private schools and has resulted in India's already poor math and reading scores declining further.¹⁷⁸

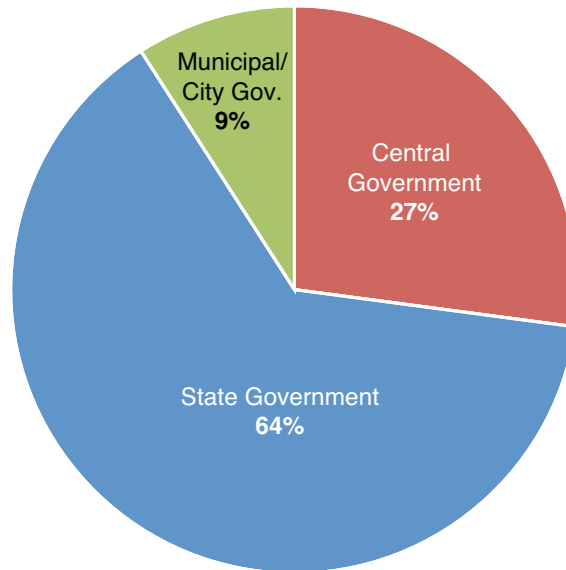
Even as reform has stalled and welfare spending has soared, India has largely failed to rein in subsidies. As a proportion of GDP, fuel subsidies grew from 1 percent of GDP in 2005 to nearly 2 percent of GDP last year.¹⁷⁹ Over a similar time frame, fertilizer subsidies grew from 0.6 percent in 2005 (193.9 billion rupees) to 1.3 percent of GDP in 2011 (671.9 billion rupees or \$10 billion at current exchange rates).¹⁸⁰

Both welfare spending and subsidies contribute directly to India's worsening business climate. Last year, credit rating agency Standard and Poor's cited India's worsening fiscal situation while warning that the country's sovereign rating might be cut from investment grade to "junk" status, which would make India the first "fallen angel" among BRIC (Brazil, Russia, India, China) economies.¹⁸¹ The need to narrow the fiscal deficit has in turn led tax authorities to become overly aggressive in their pursuit of companies. This effort puts a damper on fresh investment and encourages existing investors to consider other options.

These changes take place against the backdrop of corruption in government becoming a top concern for Indian business. Almost two-thirds of survey respondents said that, 10 years ago, corruption was not a major problem for them. Fewer than half think that way today.¹⁸² This corroborates India's slide down the rankings of Transparency International's Corruption Perceptions Index. In 2005, India stood 88th of 158 countries surveyed. In 2012, it came in at 94, below such paragons of clean government as China, Liberia, and Zambia.¹⁸³

The most prominent scandals revealed by the media over the past three years include the so-called 2G scam,

FIGURE 5
TIER OF GOVERNMENT THAT MATTERS MOST TO BUSINESS



Source: AEI/YouGov Survey

where the government may have lost the exchequer \$40 billion by auctioning telecom spectrum at throw-away prices; the Adarsh scandal, where top politicians, bureaucrats, and generals allegedly conspired to build luxury apartments for themselves on land earmarked for war widows; the Commonwealth Games scandal, which became infamous for outrageously padded procurement contracts (\$19,500 treadmills and \$80 toilet paper rolls); and “Coalgate,” in which the government allegedly lost \$33 billion by offering sweetheart deals on publicly owned coal mines to well-connected businesspeople.¹⁸⁴

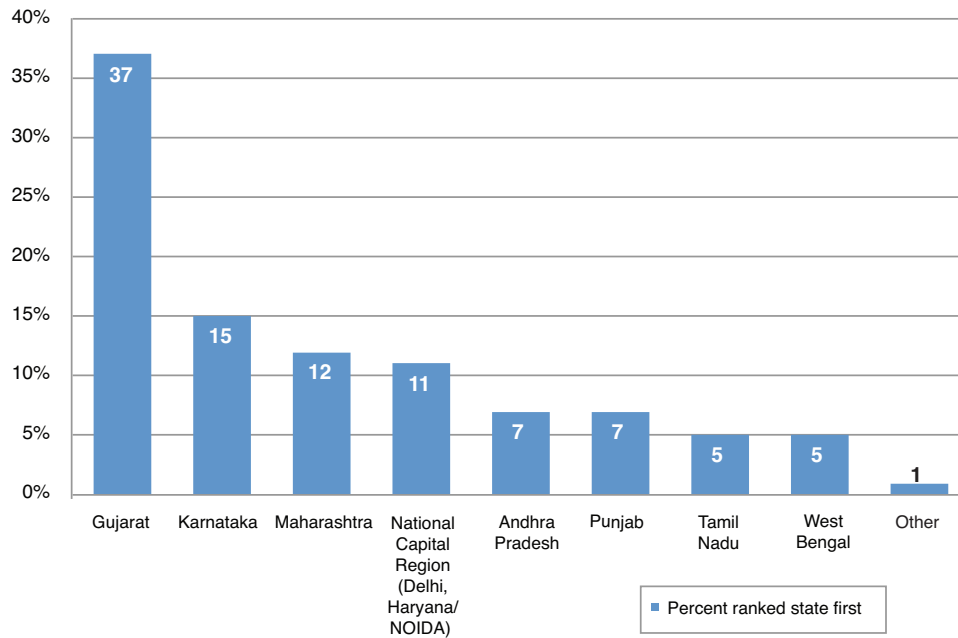
This gloomy picture notwithstanding, India’s dire economic straits ought not to be exaggerated. Though arguably reforms have been put in reverse gear in recent years, the gains India has made over more than two decades have not been lost. Between 1983 and 2013 the poverty rate declined from 44.5 percent to 22.5 percent. Had this rate remained constant, India would house 264 million more poor people today than it did just 30 years ago.¹⁸⁵

At the same time, India appears to have conclusively jettisoned autarky. The trade-to-GDP ratio rose from 17 percent in 1991 to more than 50 percent in the late 2000s.¹⁸⁶ The \$36 billion of FDI last year may

reflect a worrying decline, and look meager compared to inflows to China, but just 22 years ago *all* foreign investment in India totaled \$100 million.¹⁸⁷ Another example is industrialization. India lags much of East Asia, but nonetheless annual automobile production grew from 180,000 at the advent of liberalization to 3.23 million in 2012.¹⁸⁸

Suffice to say that just as India’s economy was probably never as strong as the hype of a few years ago suggested, it is not as weak today as the blizzard of bad news would have us believe.¹⁸⁹ India benefits from a large working-age cohort with a median age of 26.7 to support a relatively small retired population. Several other strengths that made it attractive to investors not so long ago—125 million English speakers, a large pool of competent engineers and managers, accounting and legal systems inherited from the British, and plenty of homegrown risk-taking entrepreneurs—have not disappeared. Indeed, over the past 15 years an interesting cultural shift has begun to take place among graduates of India’s elite business schools.¹⁹⁰ Increasingly, young MBA graduates have begun to view starting one’s own venture as more prestigious than joining a multinational firm such as McKinsey or Citibank. This change

FIGURE 6
RELOCATION PREFERENCES FOR BUSINESSES



Source: AEI/YouGov Survey

has been inspired in part by the success of such Indian start-ups as the travel portal MakeMyTrip, jobs site Naukri, and online retailer Flipkart.¹⁹¹

In terms of governance, the gradual shift of economic power from the center to the states is the single most promising development. Nearly two-thirds of businesses surveyed say the state government matters most to them (figure 5). A similar proportion want more power devolved from New Delhi to the states.¹⁹²

If things go right, India's best-performing states will begin to compete more aggressively with each other for investment. Repeated electoral victories for business-friendly politicians such as Gujarat chief minister Narendra Modi and Odisha's Naveen Patnaik raise the prospect of other ambitious state-level leaders beginning to view sound economic governance as the secret to political longevity.

The AEI/YouGov survey finds that businesses asked a hypothetical question about where they would relocate if setting up their business today expressed a strong preference for Gujarat as the country's top investment destination (figure 6). Other states that people would

prefer to move to include Karnataka, Maharashtra, and the National Capital Region. If voters begin to reward politicians for attracting investors, then India could enter a virtuous cycle where good economics and good politics reinforce each other.

For now, though, India stands at a proverbial crossroads. Should it embrace reform and step up growth it will quickly regain its lost luster as a rising Asian economic giant. On the other hand, should it continue to falter, it will suffer in both economic and strategic terms. Will India sacrifice an historic opportunity to transform itself into a middle-income country at the altar of shortsighted populism? Or will it return to the path of reform, unleash the productivity of its entrepreneurs, and swiftly claim a place in the front ranks of global powers? The future of one-sixth of humanity hinges on how these questions are answered.

Land. *Revisit land acquisition to reflect business concerns about cost and complexity.*

For more than 100 years, the Land Acquisition Act of 1894 has determined the government's power

to acquire private land for public purpose. Enacted by colonial authorities, this law enabled the government to take over private land without actively seeking the consent of landowners and tenants. It empowered a bureaucrat in the local administration to issue a binding decision, which was often arbitrary and open to abuse. In recent years, land acquisition by government for industry and infrastructure has led to violent protests in various parts of India.¹⁹³

A new land bill passed in September 2013 by Parliament aims to end the iniquities of the old law, but it will likely stall development by vastly increasing the cost and complexity of land acquisition.¹⁹⁴ It requires private companies to obtain the consent of 80 percent of landowners and tenants. For land acquired by the government, the consent of 70 percent of the people is required. Instead of allowing buyers and sellers to set prices, the new law arbitrarily sets the compensation amount at approximately two to four times the market value of land acquired in rural areas and twice the market value in urban areas. Land prices in urban India are already among the highest in Asia.

India's heavy-handed approach to land acquisition ignores the insight that won economist Ronald Coase the Nobel Prize in 1991: that a change in property rights only changes who needs to be compensated and by whom.¹⁹⁵ The new law effectively assigns all property rights to the landowner, whereas the old law kept them with the buyer—the government. Coase cautioned that transaction costs could prevent society from reaching the most efficient outcomes. India's law makes negotiations costly, time-consuming, and subject to endless legal wrangling. It is effectively a recipe for paralysis.

Market prices are not easily available in rural India. In many regions, transactions are few and not well documented, leaving room for officials to manipulate the figure through selective sampling or fake transactions. Distress sales constitute the bulk of the transactions, and the full value is often concealed to escape stamp duty.¹⁹⁶

Private industry will be hit particularly hard. Private firms or individuals directly buying land from farmers will also be required to make rehabilitation and resettlement payments to displaced individuals. The actual land size thresholds at which these requirements will kick in has been left to the discretion of the states. This restricts the ability of private industry to make

investments critical for economic growth.

The law also makes private buyers responsible for the rehabilitation and resettlement of those displaced. It mandates that affected land sellers be given a choice of a job, an annuity, or a one-time grant of 500,000 rupees per family. Displaced landowners are also entitled to a new house, relocation costs, subsistence allowance, and a 40 percent share of capital gains every time the land is sold to a third party.¹⁹⁷ This imposes huge costs on the buyer, not just in terms of current compensation and resettlement costs but also in terms of an effective tax on future profitability arising from dealing with the claims of those displaced. This provision of the law will adversely affect the financial feasibility of large-scale infrastructure projects and industrial projects.¹⁹⁸

*India's new land bill will likely hurt
the manufacturing sector, boost
unemployment, slow urbanization,
and hamper economic growth.*

Finally, the new law requires that before any land is acquired for industry, a report assessing the social impact of the acquisition of the land must be prepared in consultation with village councils and residents' associations. The Cato Institute's Swaminathan Aiyar calls this "a Luddite throwback to the 19th century."¹⁹⁹

These changes not only impose heavy costs on a private firm that seeks to acquire land but also extend acquisition timelines in expensive and unpredictable ways. By some estimates, it will now take an average of four to five years for any transaction involving land to be completed.²⁰⁰ Many projects that require land will quickly become unviable. Even before the new law was passed, Luxembourg-based ArcelorMittal and South Korean firm POSCO separately abandoned plans to build steel plants in India in part because of problems acquiring land.²⁰¹

In sum, India's new land bill will likely hurt the manufacturing sector, boost unemployment, slow urbanization, and hamper economic growth. India will need to reconsider this law and arrive at a more practical solution in consultation with private industry.²⁰²

Goods and Services Tax. *Create a unified Indian market by implementing a long-delayed goods and services tax.*

The Indian government has long sought a goods and services tax (GST) to boost revenues and accelerate economic growth. Similar to a value-added tax, a GST is a consumption tax imposed at each point of production, sale, and consumption of a good or service. A GST would substitute for most existing forms of indirect taxation, both central and state, including excise duty, central sales tax, state-level value-added tax, and octroi.²⁰³

By simplifying indirect taxation, introducing uniform rates, and improving compliance, a GST will enhance revenue collection and reduce tax evasion. Replacing the current patchwork quilt of indirect taxes will also move India toward becoming a genuine common market. The National Council of Applied Economic Research estimates that implementation of a GST could boost India's GDP by between 0.9 percent and 1.7 percent.²⁰⁴

According to the Economic Survey of India, indirect tax revenues contribute nearly half (46.8 percent) of central government revenues.²⁰⁵ This means that adopting a GST would impact the Indian economy more than the same reform in an advanced economy such as the United States, where government revenues depend more on direct taxes such as personal and corporate income tax.

Moreover, indirect taxes such as a GST are more efficient and less distortionary than direct income taxes, which tend to move activities away from high taxes. A GST will also likely sharply lower tax evasion in a country where less than 3 percent of the population pays income taxes.²⁰⁶ As an efficient consumption tax, which targets expenditure rather than income, a GST will almost certainly recapture some taxes people avoid paying on their incomes.

The way a GST works invariably leads to greater transparency.²⁰⁷ When a product is sold by one party to another, the buyer pays a tax on the purchase price of the product to the seller. The seller deducts from this the amount that he has already paid on the intermediate inputs used in the production process. In effect, the tax that is paid amounts to a tax only on the value added of the product at each stage. It is the manufacturer's or seller's responsibility to remit the tax to the government.

This is superior to a sales tax in two important ways. Because tax is paid only on the value added at each stage of production and distribution in the supply chain, it prevents the same product or service from being taxed twice. It also gives sellers such as shops a direct financial stake in collecting the tax because they can deduct taxes already paid at an earlier stage of production. This is particularly important in a place like India, where a culture of tax compliance has yet to take root.

In addition, the current system, which includes different rates of taxation for different commodities, often results in costly tax compliance and harassment by multiple tax authorities. And, finally, a GST will likely encourage investment by giving businesses offsets for taxes on capital.

The benefits of a GST have been widely touted by both economists and business associations in India. But its implementation has been repeatedly postponed because of opposition by state governments, which fear that they would lose revenues from taxes such as octroi.²⁰⁸ For now, businesses also remain somewhat ambivalent about the idea. Half of those we surveyed consider it a good idea, but nearly a third (29 percent) think a GST would hurt their business.²⁰⁹

This ambivalence may reflect comfort with the existing system or fear that the government will make the GST so complex and convoluted that only the biggest businesses will be able to comply with its requirements. In addition, some commentators argue that a unified national GST, with identical rates across all states, will harm Indian federalism.²¹⁰

India needs a GST, but it also needs to address the concerns of state governments and businesses. This effort will require a combination of reassuring state governments that they will not lose revenues and reassuring businesses that the new tax will lead to less, not more, scope for harassment by tax authorities.

Labor and Skills. *Overhaul labor laws to bring more informal workers into the formal sector and revamp the education system toward the modern economy.*

India hosts the world's largest workforce employed in the informal sector. The roughly 400 million informal employees who make up 93 percent of the total labor force reflect archaic and convoluted labor regulations that discourage formal employment by making it virtually

impossible for firms to fire employees during a downturn.²¹¹ In addition, firms complain that India's education system does not turn out enough readily employable workers. Many private firms devote resources to retrain workers who already hold degrees.²¹²

In India, a firm that employs more than 100 workers needs government permission for layoffs. This law makes it unwise to hire new or seasonal workers and virtually impossible to fire inefficient workers. Because of about 50 central laws and roughly 150 state regulations that overlap, businesses face a strong incentive to remain small and informal. Many economists cite inflexible labor laws as the prime reason India, unlike East Asian countries such as China and Indonesia, has failed to boost productivity by moving workers from farms to better-paid factory jobs.²¹³

Part of the problem lies in too much centralization. Both New Delhi and the states control labor laws, which means state governments can only make amendments to some central statutes; states have limited ability to add new statutes of their own. Even states that wish to make their labor laws more flexible to create more choice and opportunities for workers—among them Andhra Pradesh, Gujarat, Karnataka, and Maharashtra—find themselves stymied. New Delhi does not permit them to legislate flexibility in work hours, or night shifts for women, or give them freedom to fix the minimum wage.²¹⁴

On the flip side, many businesses find hiring workers almost as much of an issue as firing them. India's education system turns out many graduates who are virtually unemployable. The problem starts early: a widely cited report last year by the nongovernmental organization Pratham found that more than half of all fifth graders cannot read a second-grade textbook.²¹⁵ By most accounts, the problem persists beyond primary school. Businesses complain that except for a small minority who graduate from the best schools and universities, many Indian workers require on-the-job retraining.²¹⁶ Effectively this means taxing businesses twice: to fund an ineffective education system and to retrain workers to make them employable.

Instead of working to increase parental choice and reward schools that produce the best learning outcomes, India's government response—the clunky, centralized Right to Education Act passed in 2005 may make things worse. Private schools with good teachers

are burdened with onerous infrastructure requirements while their government school counterparts can attract more resources to improve infrastructure without necessarily improving learning.²¹⁷ Instead of encouraging accountability, the law has scrapped a standardized national examination for 10th graders. Finally, its focus on boosting already high enrollment rates ignores persistent teacher and student absenteeism.²¹⁸

Manish Sabharwal of TeamLease, a private recruiter, points out a strange mismatch in India's labor market. A large number of educated youth—75 percent of technical graduates and about 85 percent of general graduates—are unemployable, but at the same time firms across urban India face a shortage of skilled labor.²¹⁹ In part this is because many Indians, regardless of aptitude and circumstances, show a cultural preference for white-collar jobs over vocational ones.

On the bright side, some states have begun to see the importance of turning out appropriately skilled workers. In 2005, Tamil Nadu was one of the first states to recognize community colleges as vocational program centers through the Tamil Nadu Open University, with the purpose of skills development and job placements.²²⁰ Gujarat is working with TeamLease to address the skills gap through community colleges that offer short associate-degree programs in subjects such as finance, information technology, and hospitality.²²¹

In the long term, India's challenge is to ensure that its vaunted demographic dividend does not turn into a demographic disaster.²²² Between now and 2050, India's working-age population will grow from 800 million to more than 1 billion.²²³ To harness this dividend, India needs to create quality jobs for the 13 million workers it adds to the workforce each year.²²⁴ To achieve this goal, it needs flexible labor laws and an education system attuned to the job market.

Power. *End India's chronic power shortages by privatizing loss-generating state electricity boards and ending a government monopoly on coal.*

The world's largest blackout in July 2012 briefly plunged 600 million people into darkness and placed India's power problems under a global spotlight.²²⁵ It highlighted a perennial concern of investors and businesspeople (as well as ordinary citizens): India's shoddy infrastructure.

Over the past two decades, India has made rapid strides in improving its roads, ports, and airports, often by giving private firms a role in their construction or operation. But electricity continues to lag. Arguably, it is the single biggest choke point for the Indian economy.²²⁶

It is also the aspect of India's so-called infrastructure deficit that stands out for the entrepreneurs and businesspeople we interviewed. For the 37 percent of respondents who said that if they were to relocate they would pick Gujarat, the second most important reason was its reputation for providing uninterrupted power supplies (the first was political leadership).²²⁷

India boasts the world's fifth-largest coal reserves, and it is the world's fifth-largest electricity generator after the United States, China, Japan, and Russia. Yet its power sector remains a drag on the economy. About 15 percent of Indian power comes from captive power plants built by firms that cannot rely on state utilities.²²⁸

In 2012, India's per capita electricity consumption of 778 kilowatts/hours was one-fifth of China's.²²⁹ A staggering 300 million Indians remain off the grid. Peak demand outstrips supply by 10 percent, leading to power cuts and brownouts.

India's total installed capacity of 205 gigawatts is roughly the same as Russia, a country with one-eighth India's population. With a roughly comparable population, China produces more than five times as much power as India.²³⁰ McKinsey and Company estimates that to keep pace with demand, India will require a generation capacity of 415 to 440 gigawatts by 2017.²³¹

At its heart, India's power problem has more to do with politics than economics. State-owned electricity boards (SEBs) controlled by politicians distribute most of the power in the country. For the most part, their bosses do not allow them to charge market rates for power. Subsidized or free power accounts for about a third of state-owned electricity board losses.

In addition, state-owned electricity boards lose between 15 percent and 40 percent of power to theft. Those stealing power often do not really get it free—they pay a local politician or fixer rather than the power company. In 2012, SEB losses roughly totaled \$37 billion, or 2.3 percent of GDP.²³²

About eight years ago, while the economy was booming, India looked like it would solve its power woes by sanctioning so-called Ultra Mega Power Projects, which included some of the largest power plants in the world.²³³ Between them, the government and private players poured \$130 billion into India's power sector between 2007 and 2012; nearly half of this was private capital.²³⁴ Many of these projects are now unviable.

In recent years, India's unwillingness to charge market rates for power has been compounded by a coal crisis. Effectively, coal mining in India is a state monopoly run by a single firm, Coal India, which employs 375,000 people.²³⁵ The government invariably fixes the price of coal below international rates. Criminal gangs pilfer much of the state-owned firm's coal.²³⁶

Complex land and environmental regulations have made coal production flatline even as demand has soared. (About half of India's power is coal-generated.) Imported coal, about four times pricier than the local variety after adjustment for quality, cannot solve the problem because firms are not allowed to pass on the cost to consumers, and the power distributors are themselves often broke.²³⁷

The solution to India's power problems have long been known—privatize SEBs and allow them to charge market rates. In addition, end Coal India's de facto monopoly on coal mining to drive out criminals and spur coal supply to catch up with demand. The country's politicians will need to solve this knotty problem—one that many other Asian nations have had no trouble tackling—if India is to progress.

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About the AEI/YouGov Survey

Purpose: To assess how entrepreneurs and businesspeople in India view the business climate in the country as well as in the state where they are located.

Method: The survey was built around online responses from a sample of 594 entrepreneurs, including owners, partners, board members, chief executive officers, and chief financial officers of small and large businesses. Fieldwork was undertaken between June 12 and June 29, 2013. All results are based on this sample and therefore subject to statistical errors normally associated with

sample-based information. The sample definition set was to make the subset representative of entrepreneurs across the country with an intended skew toward the larger industrial states.

About 17 percent of the sample was from Maharashtra; 12 percent from the National Capital Region comprising Delhi, Gurgaon, and Noida; 11 percent from Tamil Nadu; 10 percent from Andhra Pradesh; 8 percent each from Gujarat and Karnataka; 6 percent from West Bengal; 5 percent from Kerala; 4 percent from Uttar Pradesh.

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Baishali Bomjan
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Sadanand Dhume
Vikram Doraiswami
Sameer Guglani
Yash Gupta
Pankaj Jain
Rajiv Kumar
Aparna Mathur
Julissa Milligan
Baijayant Panda
Mohit Satyanand
Parth Shah
Ambassador Meera Shankar
Ambassador Hemant Krishan Singh

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Sadanand Dhume
Diane Farrell
Ingrid Henick
Claudio Lilienfeld
Julissa Milligan
Ambassador Robert O. Blake
Ila Patnaik
Richard Rossow
Derek Scissors
Kapil Sharma
Sudhakar Shenoy
Anurag Varma
Ray Vickery