C.D. Howe Institute
Commentary

www.cdhowe.org No. 235, June 2006 ISSN 0824-8001

The Indian Elephant Sheds its Past

The Implications for Canada

Wendy Dobson

In this issue...

Breathless accounts of India's emergence as an economic colossus raise as many questions as answers for Canada. Is the enthusiasm about India warranted? Where does the Canadian beaver fit in with the Indian elephant? The author provides a realistic assessment of what's really going on in India, and the policy implications for Canada.

The Study in Brief

India is a land of contrasts. Indian information technology (IT) services firms are globally competitive but many manufacturers still seek protection from foreign competitors. Economic growth rates are speeding up but trade is still a small share of the world total. Logistics infrastructure is abysmal. India has the most mature and diverse financial system in the emerging market economies and many excellent universities, but the government seeks to create 100 million industrial jobs in this decade to provide employment for its 400-million-strong work force, many of whom are still illiterate.

As serious attempts are made to tackle its weaknesses and build on its strengths, India is broadening its economic reforms and establishing itself as a high-growth emerging market. Canada should be moving more quickly to deepen the bilateral economic relationship. Two-way merchandise trade flows are small. But mutual interest is growing to provide services, both directly to each other and from platforms in both countries, to serve larger regional and global markets.

While Canada's economic future will be determined mainly by its proximity to the United States, more could be made of the bilateral relationship with India. The two countries share many of the same institutions and language of commerce because of their common colonial heritage. There is a sizeable Indian diaspora in Canada. Business ties will continue to grow, but incrementally, unless governments facilitate this mutual interest.

They should consider negotiating a bilateral free trade agreement — either in services or across the board. Canadian interest would likely focus on greater across-the-board access for Foreign Direct Investment (FDI) in India, while Indians would likely push for liberalization of cross-border services provision and the movement of people. India has developed a mechanism, the Joint Study Group, for evaluating the net benefits of FTAs with other potential partners; the two countries should also take this step.

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$12.00; ISBN 0-88806-689-9
ISSN 0824-8001 (print); ISSN 1703-0765 (online)

Canadians are used to hearing breathless accounts of India's potential as an economic colossus which, though a distant market, is liberalizing its trade and investment regimes and opening to foreigners. Its IT software sector has made spectacular progress in penetrating international markets. India has the world's second-largest population and has recently embarked on talks to deepen its economic relationship with China, which has the world's largest population. Both are intent on deepening their integration with their Asian neighbors and navigating their own dynamic relationships with the United States.

Canada's economic future is largely determined by its proximity to the United States, the world's largest and richest economy. So where does the Canadian beaver fit with the Indian elephant? Is the enthusiasm about India warranted? Indicators of two-way trade and foreign direct investment (FDI) show the bilateral economic relationship to be miniscule, dwarfed by our economic interdependence with the United States. What is the basis for this mutual indifference? Can it and should it be changed?

In this *Commentary* I address these questions. The most obvious part of an answer to the last question is that the balance of global economic power is shifting to Asia from North America and Europe, and so our attention should also shift to the potential opportunities there as the breathless accounts suggest. But it is not that simple. In the next section, I examine India in the world economy, highlighting the continued ambivalence among powerful interest groups towards market forces and the protection of manufacturing and certain service sectors from competition. Both contrast sharply with the dynamic, increasingly globalized IT and business services sectors. In the third section on India's economic prospects it becomes apparent that the bright prospects for IT services exports and vibrant capital markets are offset by deeply entrenched labour-market inflexibilities and declining public institutions.

The last two sections examine the economic links between Canada and India and their implications for business and public policy. The fact that the two countries share the same institutions and language of commerce because of their common colonial heritage suggests that more could be made of the bilateral economic relationship. While merchandise trade is small, there is growing mutual interest in providing services, both directly to each other and from platforms in both countries to serve larger regional or global markets. Growth in such ties will be incremental unless governments facilitate this mutual interest with a strategic initiative to negotiate a bilateral free-trade agreement (FTA), either in services or across the board. An FTA in services is suggested as a start.

India in the World Economy

When British rule ended early in the post-war period the newly independent Indian government adopted a Soviet-style planned economy. Capitalism was

This paper is the responsibility of the author, but special thanks go to Foreign Affairs Canada for financial assistance through the Research and Conference Fund, which made possible a research visit to India. Comments on earlier drafts from colleagues, anonymous reviewers and C.D. Howe Institute economists are also much appreciated. Chester Cheng provided able research assistance.

Table 1: *The Indian Economy*

	1990	2003
GDP (Billions 2003 US$)	296	643[a]
GDP PPP Basis (Billions Current US$)	1,172	3,078
Total trade/GDP (%)	16.4	20.8
Exports/GDP (%)	7.1	9.1
FDI inward stock (Millions US$)	1,657	30,827
FDI outward stock (Millions US$)	50	5,054

Sources: IMF (2005), UNCTAD (2004b), UN Common Database (May 2005), World Bank (2005a, 2004 & 1992).

[a] Year 2004 data.

tolerated but its individualist excesses were curbed through government oversight and controls. During most of the 1950-1970 period, India's economy was largely closed as it pursued growth and development on its own. With some exceptions, the period was one of indifferent economic growth, serious droughts, and crop failures. India muddled along during those years, depending heavily on a major trading relationship with the Soviet Union and, increasingly in the 1980s, on government stimulus to keep growth going.[1]

When the Soviet Union collapsed in 1990, India's main export market went with it and the country plunged into a balance-of-payments crisis the following year. At the time, Manmohan Singh, the current prime minister, was the finance minister who recognized a window of opportunity opening for market-oriented reforms. In July 1991, he introduced a number of policy changes in a budget that seemed radical at the time: liberalizing the trade regime by removing import controls, reducing customs duties and allowing more flexibility in the exchange rate regime. Licensing controls on private investment were abolished, taxes were cut and some public sector monopolies were dismantled. Since then, India's economic performance has improved dramatically (Table 1). On a purchasing power parity (PPP) basis, the economy has tripled in size.

But some major challenges persist.[2] One is fiscal deficits. Government borrowing crowds out private-sector borrowing and deficits hamstring publicly funded infrastructure modernization initiatives. India is similar to Canada in that it has a federal structure consisting of weak coalitions at the centre and strong states, many of which spend more than the revenues they take in. Total government deficits stretch back to the 1980s. India's public-sector debt, including the debt of public enterprises, reached 95 percent of GDP in March 2003, but has since begun to stabilize. Most of this debt is held by domestic financial institutions. One of the most intractable sources of spending growth is public-

1 See Panagariya (2004) and Rodrik and Subramaniam (2004) for a debate about when and why India broke out of its modest "Hindu" annual rate of growth at 3 percent and embarked on a new trajectory of 5 percent annual growth.

2 The data in this section are drawn from World Bank (2004a).

Table 2: *The Indian Population*

	1990	2000	Avg. Annual % Growth
Population (Millions)	849.5	1064.4[a]	1.7
Size of Labour Force (Millions of Men and Women 15-64 years of age)	333.2	417.4	
Under-5 Mortality Rate per 1,000	123	90[b]	
Adult Literacy Rate (% people 15 years and above)	48	61[b]	

Sources: UNICEF (2004), UN Common Database (May 2005), World Bank (2004 & 1992).

[a] Year 2003 data.

[b] Year 2002 data.

sector salaries and, increasingly, pension liabilities; in many occupations average public-sector salaries exceed comparable private-sector pay by 2.3 times.

A second challenge is population growth. Since 1990, the population has grown at an annual rate of just under 2 percent, a rate that, if it were to continue, would double the 1990 population to 1.7 billion people by 2031. More than 70 percent of India's one billion people still live in the countryside; nearly a third still live in absolute poverty. The literacy rate of people over 15 years of age is only 61 percent (Table 2); female literacy and school enrolment rates are significantly lower than those for males. Child mortality has declined but is still high by international standards.

Nevertheless, the economy has opened up and trade and FDI flows have risen. But while India has shone in services trade and investment, it has lagged in merchandise trade. Two-way merchandise trade accounts for only about 20 percent of its GDP (Table 1). Goods exports account for only 9 percent of GDP, a ratio that has grown little in nearly 15 years. Even in markets like the global market for garments where it has comparative advantage, market share changed little over 20 years — the share was 4 percent in 1980 and 5 percent in 2000.[3] Lack of international competitiveness in these labor-intensive sectors can be attributed to the fact that India's manufacturing existed for many years behind a wall of protectionism that is part of the socialistic bureaucratic legacy of the past. While the "licence raj" (bureaucrats controlled licences to import and export) was largely dismantled in the 1990s, an "inspection raj" persists in many states, which continues to erect informal barriers to private businesses. Even so, India has developed expertise in some higher-value-added manufacturing where it is also an emerging international investor. This includes pharmaceuticals, biotech, oil and gas, and more recently, autos.[4]

3 Srinivasan and Tendulkar (2003).

4 Outward investments during 2003 alone in the auto sector were nearly US$1 billion invested in 10 companies in Australia, France, South Korea, Sudan, United Kingdom and United States (Merchant 2004). Fifteen percent of 2004 auto production was exported.

Figure 1a: *India's Commercial Service Imports, 1997–1998 and 2001–2002*

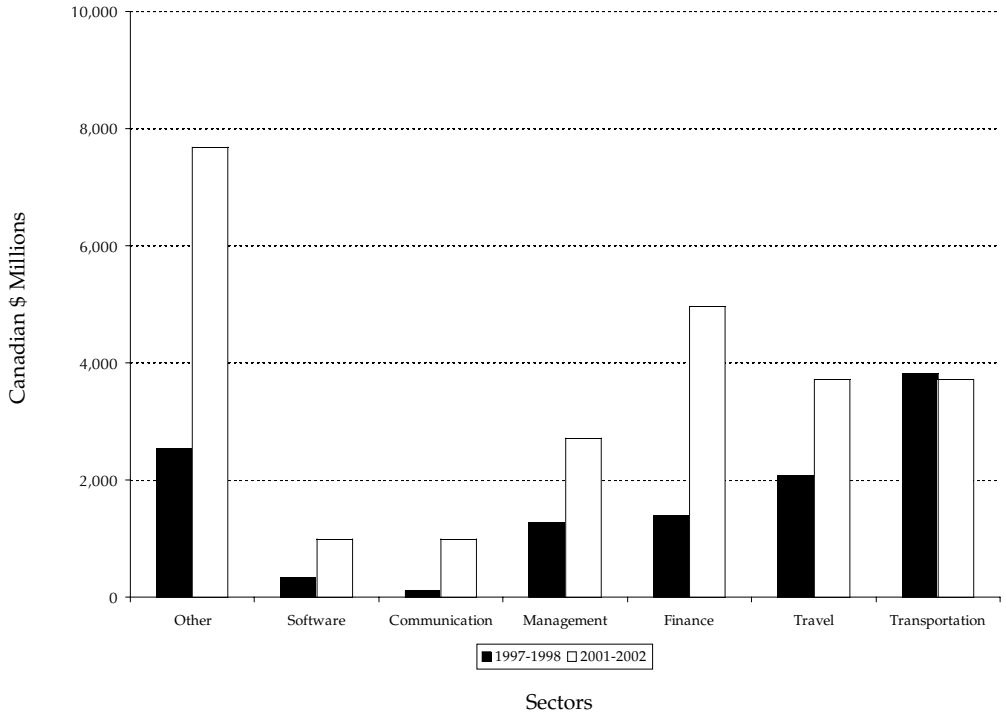
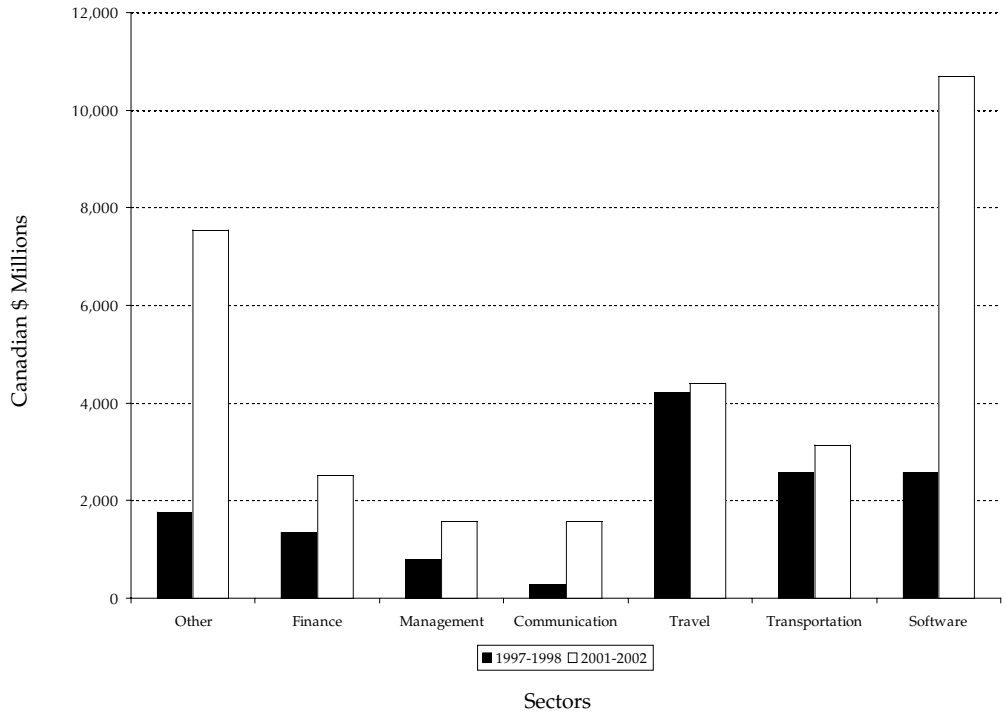


Figure 1b: *India's Commercial Service Exports, 1997–1998 and 2001–2002*



Source: World Bank (2004a). Data are reported in Canadian dollars converted at annual average exchange rates from the Bank of Canada.

Table 3: *India's Top IT Software and Services Exporters, 2002-03 (US$ Millions)*

Company	Export value
Tata Consultancy Services	963
Infosys Technologies Ltd.	751
Wipro Technologies	591
Satyam Computer Services Ltd	424
HCL Technologies Ltd	324
Patni Computer Systems Ltd	194
Mahindra British Telecom Ltd	135
IFlex Solutions	126
HCL Perot Systems Ltd	95
NIIT Ltd	90
Polaris Software	78
Birlasoft Ltd	73
Mphasis BFL Ltd	71
Pentasoft Technologies Ltd	63

Source: UNCTAD (2004b:300).

In contrast to manufacturing, India's notable trade success lies in knowledge-based, particularly IT services, exports. It is a major exporter of commercial services (Figure 1) with software accounting for more than a third of the total earnings from services exports in 2001/02, followed by travel and tourism. Services imports are about 80 percent of its exports; half of these imports are transportation, travel and financial services. The list of private companies in the software sector is growing; the top 15 accounted for US$4 billion in exports in 2002/03 and have affiliates in 14 countries (Table 3).

What are some of the reasons for this success? Use of the English language and common law, and the supply of technically trained postsecondary graduates are an important part of the answer. But another is the perverse impact on entrepreneurs of India's regulatory thicket. Restrictions have protected goods production and trade but encouraged the IT revolution. In the 1970s, the Hindu nationalist BJP government required foreign multinationals to dilute their equity holdings in their Indian subsidiaries by selling shares to Indian investors. Rather than comply, IT companies like IBM left the country and created a vacuum that Indian firms moved to fill. Some of these firms also entered the IT sector in reaction to India's restrictive trade regime. Domestic entrepreneurs were prevented from importing and exporting computer hardware in the 1970s and 1980s. Some persisted and built hardware businesses anyway; others shifted their focus to software and what goes on inside computers, creating a "virtual" industry

that was free of the regulatory and infrastructure obstacles obstructing merchandise trade.

Trade liberalization in 1991 made it attractive for foreign firms to return to India, where they concentrated on software development and call centers. Indian companies continued their hardware businesses built up since the 1970s but also increasingly turned to software. One firm's experience gives some insights into how the opportunities for interaction between foreign and domestic producers contributed to the industry's evolution. Wipro, now a global company with 40,000 employees, began as a vegetable oil producer, moved into IT manufacturing and then spotted a special niche in services and in reselling hardware. Wipro became a systems integrator providing network solutions. GE was their first partner/customer in a software contract and together they produced designs for the Indian market until 1991 when global worries about the Y2K software glitch stimulated demand for India software skills and provided a steep change in revenues. Today, Wipro has a product design and development niche in the global market for R&D services.[5]

Since the early 1990s, the services sector has driven India's accelerated domestic economic growth and trade. Growing at an annual rate of 9 percent, it has accounted for nearly 60 percent of overall economic growth during the period. Services exports grew at over 17 percent annually, mainly supplying business-process outsourcing services and IT to offshore customers.[6] NASSCOM (the National Association of Software and Services Companies, the IT industry association), and McKinsey Consulting predict that India's exports of back office and remote services, such as parts procurements for manufacturers, will be a $60 billion business by 2010.[7]

Yet this dynamic outward-oriented sector has limited linkages with the domestic economy and labor-supply constraints are increasing. During the rapid growth in output and exports in the 1990s the sector's share of total employment declined. By recent predictions, in 2007/08 India's IT offshoring sector will have a work force of only 1.45–1.55 million people but generate 7 percent of India's GDP.[8] Wages and turnover in the engineering talent pool are rising. While India produces hundreds of thousands of engineers annually, graduates from institutions outside the Indian Institutes of Technology lack comparable skills and facility in English.

India's Future Prospects

India's living standards today in dollar-adjusted terms are where China's were in 1986 when it was still early in its reform process.[9] Like China, its future economic prospects depend on the government's willingness to continue to restructure and modernize the economy.

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5 Author's interview with Dr. A.L. Rao, December 2004 in Bangalore.

6 Compared to 16 percent growth in China, 7 percent in Canada and 6 percent in the United States.

7 As reported in *The Economist* (2005c).

8 Farrell et al. (2005).

9 Maddison (2001).

India's labour force is around 400 million people but only 7 percent of the jobs are in manufacturing.[10] The Tenth Plan (2002–2007) calls for the creation of 100 million jobs in the industrial sector in the next decade. Between 75 and 110 million labour-force entrants are expected in that period, which means that around 145 million new jobs need to be created just to keep unemployment from rising. Studies show, however, that the industrial and service sectors are constrained by product market distortions (preferential policies for small firms, tax distortions, FDI restrictions); by many permits (10 in India compared to 6 in China) and long waiting times (90 days in India compared to 30 days in China) to start new businesses; by factor market inefficiencies (restrictions on hiring and firing workers); as well as by lack of access to credit for small- and medium-sized enterprises (SMEs), lack of creditor rights, obstacles to land transfers, outdated bankruptcy laws that hinder exit, and the well-known infrastructure bottlenecks.[11]

A central question about India's future prospects is whether vested interests will permit sufficient reform and restructuring to sustain long-term growth. Economic analyses of the sources of growth focus on a country's factor inputs such as capital; labor (and land); its technology; and, more recently, its institutions.[12] In the next section, I examine aspects of India's key factor markets, as well as its record on technology and its institutions. Students of innovation-based growth stress the importance of institutions that protect property rights, an effective legal system to promote arms-length transactions and institutions that balance the needs of innovators within the firm with those of outside investors (Trefler 2005:4). As will be apparent, India has its strengths, but also significant weaknesses.

Capital and India's Financial System

India's financial system is quite good at mobilizing and allocating capital, but savings and investment rates are low. The savings rate, at around 30 percent of GDP, has risen in the past few years but the investment-GDP ratio is only around 30 percent, partly due to fiscal crowding out.[13] Savings are intermediated by one of the most mature and diversified financial systems in the emerging market economies.

The banking system is sound, perhaps too sound, absorbing resources that could be better deployed elsewhere in the economy. But it is heavily regulated, state ownership is still pervasive, banks are highly risk-averse and bank assets are highly concentrated in the public sector institutions. Twenty-seven banks representing some three-quarters of total bank assets are at least 51 percent state-owned. The other quarter of bank assets are held by 40 private sector and 33

10 One basis of comparison is China. In 2000, China's labour force numbered nearly 800 million people; urban manufacturing provided 100 million jobs.

11 World Bank (2004a).

12 See North and Thomas (1973) and Romer (1991) among others.

13 IMF 2005b.

foreign banks.[14] Foreign banks with more than 10 percent holdings in local private banks are closely supervised.[15]

The traditional view of the Reserve Bank of India (RBI), the banking regulator, is that banks should assist economic development. Thus governments rely heavily on the banking system to buy the many bonds issued to finance their deficits (up to 40 percent of the assets of some banks are tied up in government-issued financial instruments). The RBI also presses banks to charge low interest rates on loans to agriculture and small enterprises.

Banking reform is slowly gaining ground as new entrants fan the winds of competition and as the RBI seeks to consolidate the less efficient institutions. Nearly 40 of India's banks are listed on the stock exchanges and 59 are sufficiently transparent that they are publicly ranked and scrutinized by financial analysts.[16] A 2005 Roadmap for foreign banks permits foreign banks to make small investments in private banks and in banks that need restructuring and, after 2009, permits foreign banks to acquire up to 74 percent ownership of private-sector banks.[17]

Yet SMEs complain of difficulties accessing credit. Micro-finance institutions reach only 5 percent of India's poor compared to 60 percent in Bangladesh, where the model was pioneered. A recent World Bank survey reports that 79 percent of rural households do not have access to formal lending; because of official interest-rate caps, banks concentrate on affluent customers and avoid the rural market — unless they can circumvent regulations with bribes.[18]

The insurance sector is no longer a state monopoly but is still heavily regulated. Rules for foreign ownership are less restrictive than for banks, giving insurance companies an edge in growing their businesses. Private domestic and foreign financial-services firms are slowly gaining market share by providing consumer financing, consumer leasing, investment banking, underwriting, portfolio management, venture capital and foreign exchange advice all through a mixture of both state-owned and private entities.

India's capital markets are the jewels of the financial system. They are among the most dynamic in the world: the corporate bond market is extremely lively; more than 5000 companies are listed on the Bombay Stock Exchange. In short, while the slow liberalization and consolidation of India's banking system is long overdue, its capital markets are well developed, diverse and contribute significantly to long-term growth prospects.

India's Labour Markets

India, obviously, has abundant supplies of low-cost labour. Some observers conflate India's increasing population and abundant supplies of labour into an economic strength. Such a generalization is misleading because of distortions on both sides of the labour market. On the supply side is a skills distortion. India's

14 Prasad and Ghosh (2005).

15 *The Economist* (2005a).

16 See *Business Today* (2005).

17 Reserve Bank of India (2005).

18 *The Economist* (2005a:22).

education system produces hundreds of thousands of engineers each year, but its accomplishments in basic education are dismal. In 2000, only 46 percent of India's children had five years of primary education. Female literacy is 70 percent of male literacy and the net enrolment rate of girls in grades 1–5 is only 80 percent that of boys.[19] Enthusiasm about India's potential labour supply must be tempered by the lack of access to formal sector employment due to the absence of even basic literacy among millions of people.

On the demand side of the labour market, outdated restrictions imposed to protect labour create additional distortions. Labour is, in effect, a fixed rather than variable cost of production. Companies with more than 100 employees must obtain approval from state governments to lay off workers. Other rules restrict certain sectors to inefficient small-scale production. Perhaps appropriate to circumstances in the 1930s, these restrictions have the perverse effect of undermining incentives for the private sector to hire new workers and generate new jobs.

Despite the ambitious Tenth Plan jobs goal and a clear call for jobs and basic health and education services from the electorate in the May 2004 election, the best the central government has been able to promise is 100 days of paid work a year in a (public sector) job for every low-income person who wants one. Even this promise has been watered down in Parliament.

The Role of Technology and Institutions

Some of India's basic institutions do encourage innovation and there is a rich entrepreneurial history despite the many bureaucratic obstacles. India also has a large middle class that often prefers Indian to international brands; sophisticated domestic competition exists in the automotive engineering design, IT, and in deregulated parts of the financial sector.[20] It has a strong legal framework although there is a huge backlog of cases before the courts. The postsecondary education system generates the skills on which India's offshoring services revolution has been built. India's venture capital markets make it possible for entrepreneurs to create startups and find financiers who can plan an exit through IPOs in the stock markets.

A key criticism of Indian R&D tends to be that Indian firms under-invest in innovation and new technologies, with most of their expenditures aiming to adapt existing technologies and products to the Indian market. As a result of intense lobbying by the auto and pharmaceutical industries, recent tax and patent law revisions are beginning to change that. Indian companies are now beginning to spend on R&D due to recently introduced tax reductions that weight spending on R&D and accelerated depreciation for R&D equipment purchases.[21]

India's strengths in finance and its rapid emergence as an innovator in IT and commercial services have drawn international attention to it as an emerging economic colossus. These predictions overlook the role of other institutions which

19 World Bank (2004a).

20 See, for example, Prakash and Metcalf (2005).

21 See a recent survey of Indian R&D at http://knowledge.wharton.upenn.edu.

"intermediate" the creation and diffusion of new ideas and technologies.[22] While India's is a market economy, there is a striking gloominess among many observers about the slow decline in its democratic institutions and public service.

"Attitudes," a code word for corruption and vested interests, put sand in the wheels of change and distort economic decision-making. One of India's most persistent constraints is the informal self-serving arrangements among politicians and bureaucrats that have grown up in its import-substitution, socialist past. Bureaucrats have taken their role in regulating markets so seriously that dislodging them after 50 years is a nearly impossible task. The administrative vacuum left by the British, according to one astute observer, was filled by the *neta babu raj*. *Neta* refers colloquially to politicians and *babu* is the term for bureaucrats. They scratch each other's backs; the civil service, instead of keeping an eye on the national interest in dealing with politicians, has joined hands with them in pursuing their own interests. There are, of course, significant exceptions, but economic change is obstructed at every turn by deeply vested interests in the status quo.[23]

Change has come about in spite of these problems, in part through the evasion of increasingly dated bureaucratic restrictions, rather than head-on confrontation with them. The promise lies in new processes made possible by India's IT prowess.[24]

In summary, I have enumerated some of the strengths and weaknesses that will significantly affect India's future prospects. One is tempted to ask how these compare with China. There is considerable discussion of the comparison but no clear conclusion because each has different strengths and weaknesses. In the next section I make a short digression to explore this topic.

How and Why do India and China Differ?

Although both countries adopted central planning models in the late 1940s, each abandoned those models in different ways with different outcomes. After unexpectedly successful experiments with rural reforms, China followed a proven "East Asian model" of opening the economy to the world, promoting export-led growth based on manufacturing, and encouraging foreign investment and technologies. It gradually eased restrictions on rural-urban migration and invested heavily in modern transportation and communications infrastructure. Indian economists have noted that one of the main reasons for differences between the two economies today is China's shrewd and successful economic policies. While the Indian government introduced trade and financial reforms, bureaucracy and powerful vested interests have resisted a comparable opening of the economy to international competition and foreign investors. Although labour never faced restrictions on migration, ideology has nevertheless slowed labour market reform.

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22 See, for example, North and Thomas (1973) and others on the role of institutions.

23 Tully (2003); Acharya (2004).

24 IT innovation in the public sector has been resisted by public servants who extracted promises of no job losses as the price of allowing innovations to go ahead (World Bank 2004a).

The savings and investment rates are also very different. China has the world's highest savings rate at 43 percent of GDP, compared to India's 30 percent. China's investment-GDP ratio is climbing annually towards an unsustainable 50 percent, while India's ratio is around 30 percent. But India is better at channeling savings to productive uses, while China's financial system is its Achilles' heel. State-owned banks, all of which have struggled with large stocks of non-performing loans, dominate the system and are unable to intermediate savings efficiently. Excess capacity in many industries suggests that capital has been wasted, offsetting some of its productivity gains. China has yet to create functioning capital markets. In contrast, India's financial system is vibrant and diverse; its weakness, however, also lies in the state-owned banks that are weighed down with government debt.

China's manufacturing miracle is explained by many things, particularly the following: the decision to open the economy to international competition; the withdrawal of government from ownership and production since 1978; a superior infrastructure (India's infrastructure services are 50–100 percent more costly); an education system that has largely abolished illiteracy and supplies low-cost skilled manpower through controlled rural-urban migration; and access to foreign technologies and savings in the large stock of FDI.

India's services successes are also built on its large pool of postsecondary graduates with technical qualifications and good English language skills, on collaboration with most of the world's leading IT firms, and on government decisions to avoid the restrictions that have hampered traditional industries. Interest groups and India's long-established successful private-sector manufacturing companies have resisted the liberalization of FDI in manufacturing and professional services, but this is now changing.

Both countries have some excellent universities, but India has a large English-speaking elite that China still lacks. India's biggest dilemma is that it cannot raise the living standards of the vast majority of rural Indians without labour-intensive manufacturing that creates large numbers of jobs for the vast pool of urban and rural unemployed. India's Commerce Minister aspires to a "techno-manufacturing future," and, indeed, in the past year the sector expanded at a 10 percent rate. Demand for Indian-made mobile telecom equipment is exploding.[25]

Whether each will just be a big player in the region or a global power will depend heavily on their success in reforming basic institutions, particularly the role of the state in the economy. One of the main lessons to be learned from the rise of the OECD economies from subsistence agriculture to modern industrial economies is that economic growth, to be sustained, requires market-friendly institutions and policies and a large amount of autonomy for the private sector.

One of the most significant recent developments is the rising cooperation between the two governments and between firms in key industries. The April 2005 accord signed between the Indian and Chinese leaders is a watershed event that is spearheading closer cooperation. Before that summit, a Joint Study Group (2005) published a report that contains an exhaustive analysis of bilateral trade, FDI and economic cooperation as well as an examination of a possible bilateral free-trade agreement. Trade is growing at double-digit rates. Two-way FDI flows are

25 Johnson (2005).

growing. The best known Chinese investment is telecom equipment manufacturer Hauwei's multi-million dollar investment in a major R&D unit in Bangalore to tap India's talent pool. Another firm, ZTE, has licensed technology to ITI, a government-owned manufacturing firm in India. Most of India's leading IT firms have established R&D centers in China and Indian machine-tools manufacturer Bharat Forge has gained control of China's largest forged-components unit.[26]

Canadians need to be aware of the deeper integration that is underway within the Asian region, and there are good reasons they should be looking at India as an entry point into this dynamic scene. But realism about India's weaknesses is also required. Canada's economic relationship with India is examined next.

Canada and India[27]

Bilateral economic integration is minimal, despite the presence of a large Indian diaspora in Canada, common ties through Commonwealth membership that stretch back to India's independence, and many common institutions such as parliamentary democracy and legal systems based on common law, English as the language of commerce and a longstanding Canadian program of official assistance.

The Record in Trade

Canada's two-way merchandise trade with India, at C$2.5 billion in 2004, is very small and probably underestimated (Figure 2). But FDI flows show a bright spot. Merchandise exports are concentrated in agriculture (fertilizers and vegetable products) and natural resources (pulp and paper), but electrical machinery and various kinds of equipment account for more than 18 percent of the total. While paper exports are growing, pulp exports have dropped by half since 1990. Canada's imports are what one might expect: textiles and apparel were nearly a third of the total, followed by organic chemicals and jewelry. Services trade is reported only in terms of receipts and payments. In 2002, Canada's exports to India were less than half a percent of its total services exports, while its imports were 0.29 percent of its total services imports (Statistics Canada 2005). India's share of our services trade ranked below that of nearly all of the OECD countries, and below that of China as well (Trefler 2005).

What are the reasons for the mutual indifference that these small trade flows imply? The first reason: foreign policy differences in which India's nuclear program plays a central role. When India announced its first nuclear test in 1974 some of the inputs came from a research reactor provided by Canada. Relations chilled again between 1998 and 2001, during growing tensions and a nuclear standoff with Pakistan, but high-level visits by Canadian politicians have since revived relations.

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26 See Mani (2005), Merchant (2005) and UNCTAD (2005:156).

27 All dollar amounts in this section are in Canadian dollars.

Figure 2a: *Canada's Merchandise Trade with India–Imports 1990–2004*

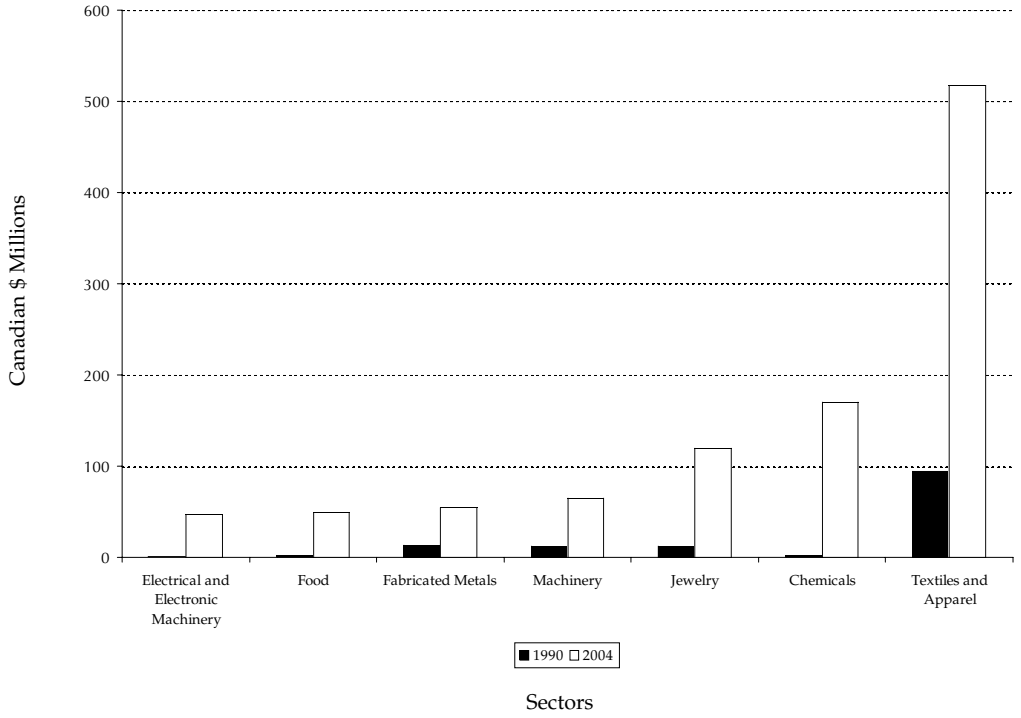
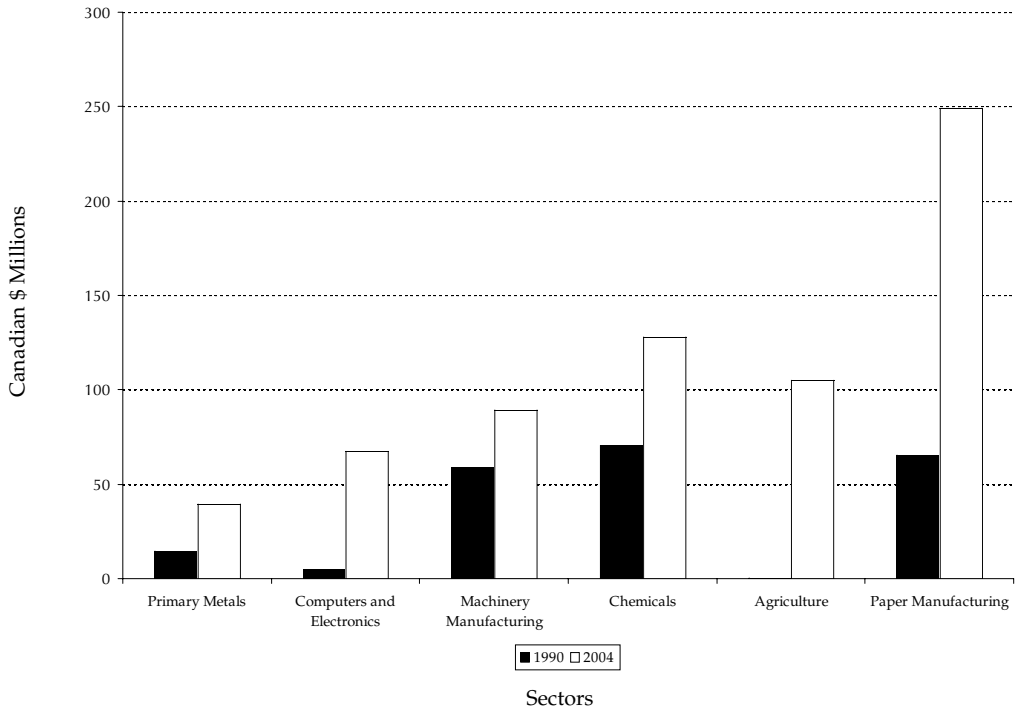


Figure 2b: *Canada's Merchandise Trade with India–Exports 1990–2004*



Source: Statistics Canada (2005).

A second reason is distance from, and lack of familiarity with, the Indian market. Canadian business initiatives in the Asian market have traditionally been relatively few in number and characterized by conservatism and failure to follow through. One of the obvious reasons is the proximity of the wealthy, dynamic American market as a ready alternative. Head and Ries (1996) argue that market failures such as inadequate market information are reasons Canadians forego significant economic opportunities in the region.

There are notable exceptions. Nortel played a role in the origins of India's IT offshoring industry. In the late 1980s, Bell Northern Research experienced significant skill shortages in North America that encouraged its business leaders to search for foreign resources. Realizing that India was developing strengths in this area, as demonstrated by Tata Software's publicized successes, they decided to offshore their product development work to India.[28] Bell Northern was also willing to share its intellectual property (IP) with its Indian partners. This example of an Indian firm winning the trust of an alliance partner deeply impressed industry leaders and today is cited as one of the factors behind NASSCOM's emphasis on protection and enforcement of IP rights. This reputation for IP protection helps to differentiate Indian firms from their competitors in other countries like China and is essential to their future success in developing their own products for licensing to others.

A third reason is India's reputation for restrictive trade and FDI regimes and difficulties doing business there. While India's investment regime is improving in world rankings the improvements are offset by infrastructure weakness.[29] FDI is still not permitted in agriculture,[30] professional services, such as accountancy and legal services, or public services, including postal and rail transport services.[31] But the negative list approach introduced in 2000 (allowing wholly-owned enterprises except where licensing or equity ownership restrictions persist, or where there are sector-specific restrictions) permits 100 percent ownership in non-bank financial institutions (non-state banks and insurance are both capped at lower levels); email providers; non-public petroleum companies; housing and real estate; coal and lignite; tea plantations; print media; TV software production; drugs and pharmaceuticals; roads, highways, ports, harbors and metros; mineral exploration; and courier services.

Infrastructure deficiencies are a major problem. IMF (2005) studied FDI inflows on a state-specific basis and concluded that specific policy inducements are not a substitute for a better business climate. Broader policies, specifically corporate taxes, trade openness, regulatory quality and regulatory burden, need reform.[32] Eighty-two percent of the firms in a World Bank (2002) study identified

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28 Author's interview with Rajiv Mody, CEO of Sasken, December 2004 in Bangalore. See UNCTAD (2004) for a more formal analysis of the same point.

29 IMF (2005) reports AT Kearney's *Global Competitiveness Report 2003-04* as ranking India 41st out of 102 countries (with 102 being most restrictive) in terms of the restrictiveness of foreign ownership (China was 81st).

30 IMF. Ibid.

31 World Bank (2004a).

32 IMF (2005).

India's uncertain electrical power services and delays in connecting electricity as serious obstacles to doing business there.

Foreign Direct Investment

Despite the mutual indifference, FDI stocks are growing on both sides. Between 1990 and 2004, the stock of Canadian FDI in India almost tripled (to $251 million from $94 million), while between 1999 and 2004, India's stock of FDI in Canada more than tripled from a much smaller base (to $62 million from $18 million).[33]

A recent survey by the Asia-Pacific Foundation of Canada (APFC) of 43 firms active in India provides more detail.[34] According to this survey, the stock of FDI by these firms alone totaled C$284 million (which implies under-reporting in the official statistics because of certain bilateral tax treaties that Canadian and other international investors use). Fifty percent of total investment was in financial services, followed by the power sector and IT. Together, these sectors accounted for 85 percent of Canada's outward FDI to India measured in the survey. The distribution of sales indicated financial services topped the list with 31 percent, electric power equipment and services followed at 25 percent, and information and communications technology at 13 percent of total sales.

What is happening in these sectors of demonstrated Canadian interest? In financial services, the RBI Roadmap for foreign banks gives Indian banks until 2009 to prepare themselves for greater competition when the market will open. But even then, foreign stakes are capped at 74 percent. Canadian firms are active nonetheless. Scotiabank provides commercial banking, treasury and trade services through a five-branch network. ScotiaMocatta India is a major participant in the import and sale of gold and silver bullion under a special RBI license. Sun Life has a joint venture with the Aditya Birla Group, known as Birla-Sun Life, to supply insurance and wealth management services.

In the energy and power sectors, while bureaucratic restrictions have inhibited hydrocarbons development, exploration was opened to foreigners in 2002. State-owned Oil and Natural Gas Corporation (ONGC) and privately owned Reliance Group have taken on foreign partners including Calgary-based company, Niko Resources (with Reliance). It has made gas discoveries in Gujarat and is engaged in seismic analysis and drilling off the east and southeast coasts.

Environmental and energy efficiency standards provide another emerging opportunity as the electricity sector seeks to become less inefficient (from massive theft of electricity from the distribution systems, under-pricing of electricity to agriculture, declining investment, frequent brownouts and blackouts).[35] Canada's participation in power generation stretches back many years through CIDA contracts for infrastructure and power-related engineering services. SNC Lavalin entered the Indian market 40 years ago through CIDA contracts and today regards

33 CANSIM (2005).

34 Assanie and Woo (2004).

35 Acharya (2004).

India as an important market with governments or multilateral institutions like the World Bank as its clients.[36]

The information and communications technology (ICT) sector has India's most liberal FDI regime with few explicit barriers and 100 percent foreign ownership permitted. Most Fortune 100 companies have Indian software subsidiaries. Telecommunications has attracted the largest share of FDI. (Since 1991, long-distance and wireless charges have declined.) Major Indian firms, including Tata Consultancy, Wipro, Infosys, HCL Technologies, Ittiam and Sasken, are beginning to build sustainable contract R&D businesses. FDI in the ICT sector is now considered to be late in the game as construction and labour costs rise, but trade opportunities for cost reduction through offshored services are still plentiful and advantageous.

Pharmaceuticals and agri-business are other sectors where Indian business opportunities should interest Canadians. Large Indian pharma companies, such as Biocon, Ranbaxy, and DRL, are now international players that started two or three decades ago as generic drugs producers when India's IP regime provided a competitive advantage by protecting processes rather than products. Following a World Trade Organization-induced policy shift in 2005, India changed its regime to product protection, which leveled the playing field for foreign firms. Contract research organizations (CROs) are now entering the Indian market to take advantage of low-cost, well-trained English-speaking Indian talent and willing institutions. Quintiles, for example, expects to employ nearly two thousand workers by 2010.[37] In agriculture, government has placed a new emphasis on the development of food chain infrastructure to kick start exports, double farm sector production, and create rural employment.[38]

Implications for Canadian business

The modest footprint of Canadian-Indian business has three parts: Canadian firms serving the Indian market or using India as a base for an Asian network for exporting and investment; imports by Canadians of Indian services to increase firm competitiveness in the North American market, particularly the US market; and dynamic Indian IT software firms locating in Canada to provide integrated customer solutions.

Expanding Canadian Trade and Investment in India

Unilateral liberalization of India's FDI regime in many goods and services sectors presents opportunities that more Canadian firms should grasp. The attractions include the large domestic market, increasing regional integration and large pools of skilled labour — particularly in engineering capabilities and networks of suppliers and related companies. Opportunities abound in services. Although

36 Assanie and Woo (2004).

37 Knowledge@Wharton (2005).

38 Johnson and Merchant (2005).

manufacturing is still hindered by regulations and lack of infrastructure, the auto and auto-parts industries have substantially improved quality, design and cost competitiveness in the past decade. Luthra et al. (2005), for example, reports Indian strengths in process engineering skills used to re-engineer processes, making them more labour-intensive and therefore attractive in other developing countries.

To take advantage of these opportunities Canadian firms must familiarize themselves with market conditions, local rules and local players. Recent industry and government initiatives have expanded the ways to do this: the Information Technology Association of Canada (ITAC) has a joint program with NASSCOM to facilitate information exchange and technical assistance; the Quebec Manufacturers and Exporters have a cooperation agreement with the Confederation of Indian Industry. The Canada-India Business Council and the Indo-Canadian Chamber of Commerce provide expert services, training and information sessions, sectoral and firm information, and also initiate group visits to increase familiarity and make local contacts. Another route is to participate in international trade shows that facilitate connections with potential local partners. A third route is to collaborate with the Indian diaspora in Canada. Estimates vary of the size of the Indian immigrant community. Canada (2005) notes there are 700,000 people of Indian descent living, working and studying in Canada, of which 300,000 were born in India. Statistics Canada (2005) reports 240,000 people of Indian descent in Canada, and Assanie and Woo (2004) put the number at 850,000. Whatever the number, little seems to be known about their contribution to bilateral trade and investment flows. Some are leveraging their market knowledge in business advisory and match-making services that recognize the intense competition with Indian producers in some markets and consumer preferences for local brands in others.[39]

Importing India's Low-Cost IT services

Canadians are only beginning to realize the benefits of accessing India's IT software services, of which call centers are the best known. The benefits of importing knowledge-based services from highly specialized firms using India's low-cost skilled labour include annual cost reductions of 20 percent to 30 percent.[40] These savings are then invested in enhancing the firm's customer focus with more service offerings and in moving up the value chain, thereby raising productivity and creating new higher-skilled jobs in Canada. The value chain includes a series of increasingly complex transactions, including shared corporate services (finance, accounting, procurement), knowledge services (portfolio analysis, claims processing and risk management) and R&D (new product design and engineering).

Canada's proximity to the US market, same time zone, lower-cost skilled labor and plentiful multi-lingual skills has made it a significant supplier of call center

39 See, for example, Prakash and Metcalf (2005).

40 PricewaterhouseCoopers (2004:8).

and other back-office services to domestic and US customers.[41] But this advantage is declining as global competition intensifies and the currency appreciates. Indeed, UNCTAD (2004) reports an international survey that suggests Canada is "stuck" in call centers at the low end of the value chain. In the same study, India ranks near the top with a full offering across the value chain. As Canada's cost advantages decline, customers will seek the savings in lower-cost locations and suppliers will have to offer higher-value-added services.

One of the reasons for the Canadian cost advantage is that there is less demand for such services and therefore less pressure on wages in the sector. To explain why Canadian demand lags that in the United States, PricewaterhouseCoopers (2004:12) surveyed offshore service providers who responded that Canadian firms lack confidence and experience in seeking and using these resources. This lag might be explained by the greater number of small firms in Canada's industrial structure, concerns about privacy, customer and employee objections, and operational risks such as reliability. It might also be explained by the unfamiliarity of Indian brands to Canadians compared to the (higher-priced) services provided by better-known American IT firms. In an update to this survey, Scott and Ticoll (2005) estimate that, on average, Canadian firms invest only 43 percent of what their US counterparts invest in ICT per worker across the spectrum of industries.[42] They stress the rising competitive risks Canadian firms face if they fail to invest in these resources.

Indian Firms Locating in Canada

The third part of the economic footprint is the presence of Indian firms in Canada. Indian firms are the pioneers in developing the global business model of IT services that emphasizes quality, reliability and privacy. The leaders, Tata Consulting Services, Wipro, Infosys, Satyam, offer "front office" high-value-added knowledge and design services that require close collaboration with their customers. Their presence adds to the competitive climate that stimulates learning and productivity growth in Canadian firms. ITAC-NASSCOM cooperation noted earlier aims to enhance this inter-firm collaboration.

As this discussion implies, Canada has few barriers to importing IT services from India, or to Indian FDI in Canada. Indeed, Canada's immigration policy puts much value on IT skills and facilitates both temporary and permanent movement of people with such skills. Provincial governments even compete with each other to attract IT investment and provincial premiers travel to Bangalore to learn more. Surprisingly, however, the business expansion of Indian firms in Canada is constrained by at least three factors: scarcity of skilled Canadians with appropriate engineering and technical training (as distinct from the skills required for low-end

41 Compared to India's less than 1 percent share of our total services trade, nearly two-thirds (59.5 percent) of our services exports went to the United States in 2001 and 61.6 percent of our services imports originated there (Trefler 2005).

42 Health care invests 42 percent as much; telecoms 48 percent; finance and insurance: 60 percent; mining, oil and gas only 11 percent; manufacturing 25 percent; construction and professional services only 30 percent (Scott and Ticoll 2005).

call centers); the conservative attitudes of Canadian business towards using foreign service providers; and government procurement practices.[43]

Implications for Public Policy

The constraints discussed in the last section imply the need for Canada's federal and provincial governments to examine conflicting signals and objectives. The immigration and economic development departments (and presumably the premiers and the federal trade and human resources ministers) encourage foreign entry, while operational and procurement departments are known to be reluctant to use the services of foreign firms even though they employ Canadians.

At the broadest level, federal government policy is not clearly articulated, despite a joint statement by the two countries' prime ministers in early 2005 to "enhance the architecture of the Canada-India partnership." The International Policy Statement (IPS), for example, set a rather narrow goal of surpassing $2 billion in exports to India by 2010.[44]

India's evident economic momentum and the emergence of its world-class companies argue for greater Canadian policy ambition. Canada needs a comprehensive strategy that goes beyond the incremental initiatives to facilitate industry and scientific collaboration. In 2005, the two governments agreed to foster scientific collaboration in five areas;[45] they are negotiating an R&D and Innovation Program, including joint funding of commercialization projects. Since 1998, the University of Waterloo has had an agreement with the Indian Institutes of Technology to facilitate student faculty exchanges and joint research in electronics engineering, photonics and bio-sciences. International Trade Canada (ITCan) is negotiating a Foreign Investment Protection and Promotion Agreement (FIPA) to reduce the uncertainties of long-term investment by clearly spelling out the rules and creating enforceable rights for private investors.

These are all welcome incremental initiatives. The International Trade department has launched an emerging market strategy noting that while Canada's main trading partner will continue to be the United States, Canadians should also exploit the opportunities of the large emerging markets in China, India and Brazil because of their dominant roles in global supply chains. It states that government must re-evaluate and coordinate its programs and services offered to businesses engaged in trade and investment. Further, the Conservative party platform indicated an intention to explore possible FTAs with Asian countries.

The IPS provides a platform to elevate the Canada-India relationship to a strategic level through the negotiation of a bilateral free-trade agreement. Brazil, also an IPS focus, has already shown interest in a negotiation. China has not. Yet Canada is involved in negotiations with South Korea. Why not India?[46]

43 Author's interviews, January 2006.

44 Canada (2005).

45 The five areas are nanotechnology, ICT, biotech and health sciences and medical devices, alternative energy and earth sciences and disaster management.

46 This idea initially surfaced in a discussion with Arvind Panagariya.

Should Canada and India Negotiate a Free-Trade Agreement?

What follows is the rationale for deeper investigation of the potential benefits of a bilateral negotiation, not the full-blown analysis that should be an entire paper in itself.

The gains from trade liberalization are realized when foreign imports increase competitive pressures on previously sheltered domestic producers, forcing them to be more productive and encouraging the reallocation of resources to areas of comparative advantage. Some of the largest gains come from removing barriers in industries with differentiated products that both sides produce, allowing each to specialize and expand intra-industry trade. As the earlier discussion illustrated, India's sectoral strengths are in agriculture, some areas of manufacturing, pharmaceuticals and IT services. Canada's strengths are in natural resources, agriculture, some advanced manufacturing and a range of services, including engineering and environmental, financial and IT. Clearly, more detailed analysis of comparative advantage is required to sharpen and deepen these observations.

Why should Canada be interested in an FTA with India? The obvious answer lies in the opportunities for deeper integration with one of the world's increasingly dynamic large economies with which we have ties through common language and institutions and the large Indian diaspora. Each of these factors suggests the two-way economic flows should be larger than they are. An FTA negotiation would send a powerful signal of commitment to greater openness, transparency and non-discrimination to Canadians who are forgoing the efficiencies offered by Indian IT services providers regarded as "foreign" and to Canadian businesses interested in penetrating the Indian market and using India as a platform for Asian operations.

Why should India be interested? Since 1991, successive governments have sought to liberalize trade and capital flows to increase India's share of world trade and to integrate more deeply into the world economy. As well, India has played a leading role in the multilateral negotiations at the WTO. The economic relationship with Canada is small and distant relative to the potential in the United States; or China; or the nearby dynamic Southeast Asian countries. Yet India's unilateral liberalization has been a slow, politicized and incremental process. WTO negotiations are cumbersome, slow and increasingly uncertain. A multi-track strategy, such as Canada adopted nearly two decades ago, would include bilateral FTAs as well.

Indeed, India has already started down the multi-track path with varying results. It has pursued agreements with its Asian neighbors as part of its integration strategy and to check China's growing influence in the region. Two completed agreements include a Comprehensive Economic Cooperation Agreement with Singapore (August 2005) that includes goods, services, FDI, closer cooperation on standards and taxation and other areas; a similar treaty is being negotiated with ASEAN. A South Asia FTA with six neighboring countries was concluded in January 2006 but it contains some significant sectoral exceptions. Indian interest groups have so far argued against a 2005 Chinese overture to eliminate bilateral tariffs on goods.

The United States is India's obvious strategic priority in the western hemisphere, but recent analyses of the feasibility of a comprehensive US-India bilateral FTA conclude that it is a radical idea for both countries whose time has not yet come, even though it would bolster India's economic liberalization agenda.[47] A negotiation with Canada would be a significant strategic signal of India's potential importance to the North American economies. More limited preferential trade agreements (PTAs), focused mainly on goods trade, are already underway with Latin American countries; a PTA has been concluded with Mercosur (January 2004) and one is being negotiated with Chile.

What might a bilateral FTA look like? Should it be a full-blown FTA across the board that includes goods, services and FDI? India's current and completed negotiations indicate a preference for more limited goals, although the Singapore and ASEAN agreements are ambitious and included a major effort to adopt consistent rules of origin among the different partners. The option should therefore be carefully studied, but it is likely that Indian manufacturing interests would resist; and both countries might prefer to negotiate agricultural trade liberalization at the WTO, where the broadest possible tradeoffs would be possible.

Thus, it makes sense to consider, beginning with a services-only FTA and possibly expanding it to goods at a later date if desired. Private sector players in both countries have shown interest in each other's markets through bilateral flows in FDI in services. Canadians are building on strengths in financial services, IT and engineering services in power generation and the energy sector; and Indian software companies export their services to Canadian customers and establish affiliates to supply the more sophisticated services that require face-to-face contact. While there are few trade barriers to IT services, other services industries are constrained by scarcity of trained people, barriers to the movement of the people, and customers' desire for face-to- face contact with service providers.

Services are an heterogeneous group of products that share the common characteristic of government intervention and regulation. Negotiations would establish obligations and disciplines that would free up market access, ensure non-discriminatory treatment and commit partners to publish all domestic measures that constitute barriers to trade. Services trade takes special forms (called "modes" in WTO parlance) that include cross-border supply, the purchase of services by consumers traveling abroad, direct investment by producers in local affiliates, and the movement of people across borders.

The WTO's General Agreement on Trade in Services (GATS) negotiations focus on measures by central state or local governments that affect these four flows of services transactions across borders. There are two distinct disadvantages: the glacial pace of the Doha Round, and the use in such negotiations of a cumbersome "positive list" approach in which liberalizing measures apply only to those sectors in which commitments are made.[48] Recent US bilateral negotiations with Singapore and Australia, however, have covered new ground by using the more

47 Bery et al. (2004).

48 Because it was the only approach on which all WTO members could agree.

streamlined negative list approach in which liberalization applies to all sectors unless specified in the agreement.

Is there a basis for negotiation in services? It is possible, using international indices, to compare the height of countries' barriers to services trade to see where resistance might lie (but where gains from liberalization might be greatest). One index, the foreign restrictiveness index, summarizes a country's restrictions on foreign firms entering and operating in its markets. Another index, the domestic restrictiveness index, summarizes restrictions on the establishment (such as licensing, investment and permanent movement of people) and ongoing operation (legal requirements for operation and temporary movement of people) of firms.

These indices are compared in Table 4. This table includes significant countries with which Canada has FTAs (Chile, Mexico and the United States); one with which it is negotiating an FTA (South Korea); and those that the IPS indicates are of high interest (India and Brazil). China is not included because comparable data are not available.[49]

The foreign restrictiveness index highlights those countries with the most restrictive regimes in major service industries. Canada is the most restrictive in engineering and legal services while India is more restrictive in accountancy, banking (but shares high scores with Brazil and Korea) and telecommunications (where high scores for both countries, as well as Korea and Mexico, indicate relative restrictiveness towards the entry of foreign service providers). The domestic index shows that Canada is relatively more restrictive in architecture and legal services; India holds this position in accounting. In telecoms, both India and South Korea retain relatively high levels of restrictions.

These relative rankings paint a picture of the potential problem areas in negotiations where interests in each country resist foreign (and in some cases domestic) competition. But the barriers can be overcome; both Chile and South Korea, for example, have highly restrictive indices in several sectors; yet Canada has an FTA with Chile and wants to have one with South Korea.

Canada and India should extend umbrella national treatment and MFN rights to each other with respect to services. Barriers are low on both sides in the provision of IT services but as Table 4 illustrates, other barriers remain. Both countries would gain from the freer movement of skilled people (by removing barriers such as professional licensing standards, codes of conduct, and accreditation of educational institutions in both countries). Some of India's service sectors are virtually closed to foreigners and are the responsibility of lower levels of government, as is the case for services in Canada. Working groups from responsible levels of government on both sides would have to address ways to increase transparency and objectivity. In other areas, joint work on privacy and consumer protection requirements would also facilitate the temporary movement of people. Further work is also needed on respective barriers in financial services, telecoms, energy and health services that would complement and extend the current incremental initiative on R&D and Innovation.

India has used the Joint Study Group mechanism with other countries to undertake the detailed macroeconomic and sectoral analyses that are needed prior

49 Although Canada and Singapore began a negotiation some years ago, Singapore is not included here because the negotiations are languishing in obscurity.

Table 4: *Services Restrictiveness Index*

A. Foreign Index

Country	Distrib'n	Engineering	Acctc'y	Arch'tre	Legal	Banking	Telecoms
Canada	0.19	**0.33**	0.16	0.42	**0.52**	0.07	0.44
India	0.32	0.10	**0.44**	0.08	0.40	**0.60**	**0.69**
Brazil	0.23	0.23	0.39	0.16	na	0.51	0.31
Korea	**0.33**	0.19	0.12	**0.48**	0.44	0.43	0.68
Mexico	0.11	0.31	0.33	0.36	0.49	0.17	0.53
Chile	0.13	0.14	0.24	0.35	na	0.40	0.09
US	0.16	0.23	0.19	0.33	0.48	0.06	0.03

B. Domestic Index

Country	Distrib'n	Engineering	Acctc'y	Arch'tre	Legal	Banking	Telecoms
Canada	0.05	0.11	0.22	**0.25**	**0.31**	0.00	0.14
India	0.15	0.00	**0.31**	0.02	0.09	0.05	**0.39**
Brazil	0.01	0.04	0.20	0.07	na	0.01	0.21
Korea	**0.26**	0.00	0.24	0.00	0.11	0.19	0.35
Mexico	0.00	0.04	0.14	0.04	0.22	0.00	0.23
Chile	0.06	0.00	0.10	0.05	na	**0.29**	0.09
US	0.00	**0.12**	0.20	0.13	0.24	0.00	0.03

Source: Findlay and Warren. "Restrictiveness Index on Trade in Services Available at http://www.pc.gov.au/research/rm/servicesrestrictions/index. html retrieved from World Wide Web December 10, 2005.

Notes: 1. Both index scores range from 0 to 1. The higher the score the greater are the restrictions.

2. The foreign index measures all restrictions that hinder foreign firms from entering and operating in an economy.

3. The domestic index is based on restrictions on establishment (licensing requirements for new firms, restrictions on direct investment in existing firms and on the permanent movement of people) and restrictions on ongoing operations (on firms conducting their core business, pricing of services and temporary movement of people).

to official decisions on how to proceed. As with other FTAs that Canada has negotiated, support from the business community would be an important factor. But a bilateral FTA or a services FTA is the kind of initiative needed to elevate Canada's relationship with India to a strategic level.

Recommendations

The bilateral relationship is complicated by India's huge unmet needs in the UN Millennium Development priorities of basic education and health. At the same time, India's largest firms in IT services and pharmaceuticals are world-class

suppliers and competitors, particularly in Canada's largest and closest market, the United States. The IT industries in both countries are moving to deepen their collaboration. Governments should build on this development in at least two ways.

1. Elevate the bilateral relationship to a strategic level

The Canadian and Indian governments should consider negotiating a comprehensive FTA, or at least a services FTA, as a strategy to elevate the relationship and deepen economic integration. There are several potential benefits from a Canada-India FTA (CIFTA):

- The services sector's importance in the bilateral relationship will be signaled by extending umbrella national treatment and MFN rights to each other;
- Human resources availability will be enhanced by reducing the barriers to the movement (both temporary and permanent) of professional and technical personnel, for which different levels of governments have responsibilities, using joint working groups charged with introducing greater objectivity and transparency to regulations;
- Two-way flows of FDI will be facilitated by reducing barriers to market access for firms seeking to serve local markets and establish bases to serve regional markets;
- Efficiency gains would be achieved by replacing government procurement restrictions with more open competition that includes each other's suppliers.

If the two governments were to embark on FTA negotiations in services they should aim to be WTO-plus in the sense that they improve on existing WTO rules and objectives of non-discrimination and transparency. A services FTA would also have to be compatible with WTO commitments. Adopting a negative list approach to services negotiation would be a step forward. As well, an inter-regional FTA would help to mitigate concerns about a discriminatory Asian trade bloc.

2. Get the domestic environment right

Canada's International Policy Statement identifies as one of its goals a domestic environment that is competitive and supportive of international business. This *Commentary* has indicated that much can be done to improve the competitiveness of Canadian firms through learning about best practices and competing with Indian firms that are world leaders in the IT software services sector. Governments can provide leadership by setting targets for cost savings in the provision of government services and re-investing these savings or returning them to taxpayers through lower taxes. Governments should also examine their procurement practices with respect to their transparency and emphasis on obtaining the most efficient suppliers.

Public policy should also address the constraints on the growth of firms (domestic and foreign). These relate to (i) talent: Canada needs to produce and attract a larger supply of engineering and technical talent; (ii) infrastructure: governments should step up their efforts to provide world-class communications

and transportation infrastructure; and (iii) advanced services clusters: clusters of advanced firms which compete with and learn from each other need to be encouraged and supported by policies. Each of these issues has been the focus of policy analysis, but it is worth noting them here as they affect the potential of the bilateral economic relationship.

Conclusion

Contrary to the indifference implied by the beaver and elephant metaphor, Canada and India have common interests around which to build the relationship. A services free-trade agreement suggested here would raise its potential political and economic significance. The remarkable success of India's IT services exporters all along the value chain should be exploited by large and small Canadian firms to increase their competitiveness and to move to higher-value-added activities in services provided in Canada. Canadian interests would likely also focus on greater across-the-board access for FDI in India, while India would likely push for liberalization of cross-border services provision and the movement of people.

Manufacturing should not be discounted either. There are few reasons to believe that Indian ambivalence to foreign investment in manufacturing will be resolved soon, although progress is being made in other sectors. India's successes in "techno-manufacturing" need to be augmented in ways that create jobs for the rural under-employed. This will require domestic investment in infrastructure and housing as well as foreign investment in low-cost manufacturing. Over the next 20 years, as China's population ages and the quality of life in its countryside rises, real wages will also rise. India could become the next low-cost manufacturing site in global supply chains.

There will be costs and uncertainty. Liberalization of India's FDI regime is unleashing private-sector dynamism, but bureaucratic and ideological interests continue to hinder infrastructure and maintain regulatory intervention. The dynamism of the advanced services clusters masks to outsiders the huge unmet demands for basic services by hundreds of millions of low-income rural voters. It is unrealistic to assume that India will miraculously transform its entire economy in the next decade. Vested interests will slow progress, but as more people taste the fruits of growth, their demands for better lives will outweigh the interests of the defenders of the status quo.

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