William Pesek of Bloomberg Comments on Investing in India

India has long been viewed as a value investor's dream: rapid growth, 1.2 billion people pining for a taste of globalization, and underdeveloped industries ripe for turnarounds. So it surprised few when the genre's guru, Warren Buffett, placed a bet on the world's ninth-biggest economy.

What did come as a surprise, though, was last week's decision by the billionaire's Berkshire Hathaway Inc. to give up on India's insurance market after just two years. Adding to the drama, the withdrawal came the same week India unveiled plans to open the economy as never before to foreign-direct investment.

Buffett isn't alone in voting with his feet. Wal-Mart Stores Inc., ArcelorMittal (MT) SA and Posco are pulling back on investments in India that they had announced with great fanfare. What's scaring foreigners away? A rampant political dysfunction that has stopped India's progress cold.

Headwinds from New Delhi are contributing to the slowest growth rates in a decade, a record current-account deficit and a 7.9 percent plunge in the rupee this year. Fiscal neglect has bond traders demanding higher yields for government debt than India wants to pay. But the most devastating no-confidence vote is coming from the big, long-term money India needs to boost its competitiveness. Foreign-direct investment slid about 21 percent last fiscal year, and this one doesn't look promising.

Biggest Democracy

In theory, no Western executive or investor can ignore the vast potential of Indian consumers, 29 percent of whom are under age 15. India's geopolitical importance is rising in step with China's ambitions. U.S. Vice President Joe Biden, visiting New Delhi this week, is hoping to deepen Washington's bond with a possible bulwark against Beijing's influence, as well as increase bilateral trade.

The problem is an Indian government that won't get out of its own way. The long debate over foreign-investment limits says it all. In September 2012, Prime Minister Manmohan Singh's government passed a law allowing big retailers to open stores directly in India, yet no one has. Reasons are legion: too many prerequisites; constraints on whom goods can be purchased from; a raft of regulations limiting franchise models and factory construction; and the hair-pulling need to negotiate separately with each of India's 28 states.

India has fallen into a self-destructive pattern of relenting on the big issues, then killing would-be investors with the details. Take the experience of furniture retailer Ikea of Sweden AB, which in January won approval to open outlets in India. Not content with the Swedish icon investing about $2 billion, the government played hardball. It tried to bar Ikea from selling food in its stores; Ikea stood its ground. But the damage was done.

Executives fully expect to have to navigate India's notoriously bad infrastructure, rigid and often unskilled labor markets, red tape and official corruption. They're less keen on tripping over the fine print of vaguely written laws and local power brokers with agendas at odds with New Delhi. Headline-making disputes involving household names like Ikea, Wal-Mart and Berkshire don't help India's image.

Worse, the uncertainty is breeding a huge trust deficit. On July 17, India moved to open important sectors such as defense, power and telecommunications to foreign investment. It's being heralded as the nation's "big bang." Big fizzle is more like it, as big inflows are likely to continue eluding India.

Any major foreign investor cannot ignore the experience of Vodafone Group Plc, which is still wondering if it will take a multibillion-dollar loss on a deal thanks to tax-policy changes. In 2007, the Newbury, England-based carrier acquired the Indian unit of Hong Kong-based Hutchison Whampoa Ltd. Since then, a retroactive clause placed in the nation's laws have thrown the deal into chaos, creating a $2.2 billion tax dispute, delaying an initial public offering and further denting India's reputation.

Squandered Potential

It's time for the government to stop squandering India's potential. The lack of transparency and reliability makes it virtually impossible to consider long-term investments there. And even if a foreign executive has faith in the sober-minded Singh, there's no guarantee his ruling Congress party will be in power after elections next May. The opposition Bharatiya Janata Party, normally a pro-business crowd, has threatened to roll back India's new investment laws.

What should India do? Pass clear and strong investment laws that will survive the change of government and offer a code of conduct for state leaders. India must strengthen the rule of law as it applies to foreigners so they'll trust their money is safe. Finally, India must think long-term. Today's motivation for inviting more foreign money is to narrow the current-account deficit. The goal should be to raise competitiveness, gain fresh knowledge and create better-paying jobs for the future.

Along with politics, India often lets scale get in its way. There's a sense in New Delhi that India's sheer size, vast supply of cheap labor and clear potential should have China looking over its shoulder -- that companies should rush there regardless of the political tangle.

Yet India is proving that size doesn't guarantee its inevitable rise. Only true economic reform, political openness and more proactive leadership will do that -- and get the Buffetts of the world to come to India and stay.