

## Introduction

# China and India: Is the Glass Half-Full or Half-Empty?

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China and India have captured the attention and imagination of economists, business people, political observers and the general public in the early years of the new century. However, the stories about their rise and prospects vary significantly. Three different narratives have acquired prominence in the social science literature.

First, some authors have dubbed the twenty-first century the ‘Asian century’, with China and India serving as engines of global development. As indicated by David Kelly and Ramkishan Rajan (2006, 1), ‘With the exception of the crisis period in 1997–1999, Asia has been the world’s fastest growing region for the last three decades’. Hubert Schmitz (2007, 1) claimed, ‘The speed of industrialization in China and other Asian countries is breathtaking. They are not just catching up, they have begun to drive the changes in the rest of the world’. In earlier publications, Jim Rohwer (1995) placed Asia’s spectacular rise in historical and global perspectives,<sup>1</sup> while Nicholas Kristof and Sheryl WuDunn (2001) showed how Asia managed to recover from the 1997 crisis to become stronger than ever.

The views that single out Asia – and ‘Chindia’ in particular – have solid foundations. The ‘Four Little Dragons’ (also known as the ‘East Asian Tigers’) – Hong Kong, Taiwan, Singapore and South Korea – impressed the world with high growth rates and rapid industrialization from the early 1960s through the 1990s. The Giant Dragons – China and India – have demonstrated unprecedentedly high and continuous growth rates in the last two decades. They have also spurred overwhelming interest because of their large size; together they account for 37.5 per cent of the world’s population and 6.4 per cent of world output and income (Winters and Yusuf 2007, 1). Considering China’s hardware (a dynamic manufacturing sector) and India’s software

(an extremely successful IT industry), many observers think that these two countries can overtake the world.

The second school of thought recognizes that China and India are currently at the forefront of world development. However, while applauding their achievements, it denies the existence of the phenomenon of Chindia. Most of the analysts sharing this view believe that China significantly outperforms India, although some claim that it is the other way around. Yasheng Huang and Tarun Khanna in a now-famous article in *Foreign Policy* alleged that India's path is more promising compared with China's due to the extraordinary success of homegrown entrepreneurship (Huang and Khanna 2003).

The third narrative is much more skeptical and pessimistic. It questions not only the phenomenon of Chindia, but also argues that the impact of either of these two countries on the world is limited, and the prospect of continued growth is doubtful in the long run. For example, Pranab Bardhan writes: 'Severe structural and institutional problems will hobble them [China and India] for years to come. At this point, the hype about the Indian economy seems patently premature, and the risks on the horizon for the Chinese polity – and hence for economic stability – highly underestimated' (Bardhan 2005). Indeed, both China and India are still very poor countries, illiteracy in India remains very high and agriculture continues to be a dominant sector.

The authors of this volume do not share the third view. Instead, they are consistent in acknowledging the significance of China and India for the global economy. Nevertheless, there are variations in their perceptions of how much the rise of China and India matters for the world and how sustainable the growth of China and India can be. In his foreword to this book, Lawrence Summers compares the present-day 'Asian miracle' with the eighteenth-century Industrial Revolution and finds Asia much more 'miraculous' – 'the most important story of the day', he contends (xi). Summers' exuberant view is not shared by all contributors. David Dollar, for example, is much more sober. He questions the notion of the Asian miracle and prefers to highlight China's outstanding performance, that leaves India much behind: 'The "rise of Asia" is something of a myth', he writes. 'During 1990–2005 China accounted for 28 per cent of global growth, measured at purchasing power parity (PPP). India accounted for 9 per cent. The rest of developing Asia, with nearly a billion people, accounted for only 7 per cent, the same as Latin America. Hence there is no general success of Asian developing economies'. Furthermore, 'There is too much heterogeneity within Asia to make "Asian Century" a very useful concept' (48). Similarly Linda Yueh underscores the exceptional progress of China: 'When adjusted for PPP, China is currently the world's second-largest economy. It is also the world's largest country in terms of population (and

potential market), a leading destination for foreign direct investment and the one of the three largest traders' (3).

The difference in the interpretation of the present and the forecasts of the future boil down to the perception of the balance between drivers and limitations of development. Those who see the glass half-full or sometimes absolutely full emphasize the drivers of China's and India's development, such as strong human capital and technological progress, flexible labor markets, openness to the global economy and institutional environments which enable growth. Those who see the glass half-empty focus their attention on existing limitations of growth such as infrastructure bottlenecks, trade imbalances, resource scarcity, environmental degradation and too cozy relations between state and business.

This book seeks to test models and assertions with evidence from practitioners in these two countries. The book is organized in two parts. The first part provides an overview of economic growth in China and India and compares these countries' recent progress with that of the rest of Asia. The second part empirically analyzes the drivers and limitations of their growth, primarily based on micro-level data and covering a broad set of topics ranging from international trade and investment to health care and grassroots democracy.

The book is comprised of papers presented at the Eighth Annual Global Development Conference, held in Beijing, China, in January 2007. The conference was organized by the Global Development Network (GDN), an organization with the dual mission of building research capacity in social science and bridging research and policy. Similar to previous publications in the Global Development Network Series, that are designed to give voice to researchers from the developing and transition world (Aryeetey and Dinello 2007; Dinello and Popov 2007; Squire and Fanelli 2008), this book brings together recognized scholars from both developing and developed countries as well as lesser known researchers from developing countries, whose contribution to international social science literature should be noticed and regarded on its merits. Consistent with GDN's mission of promoting high-quality research in all disciplines of social science, the book assembles articles by authors representing economics, political science and sociology.

## DRIVERS OF DEVELOPMENT

Asia-watchers have suggested a variety of factors driving China's development. Dollar, for example, contends that China has grown better than its developing neighbors because it started its reform with a better base of human capital, has been more open to foreign trade and investment, and created good investment

climates in coastal cities. To further analyze factors stimulating China's growth, the following sections highlight drivers identified by Dollar – human capital, trade liberalization and a favorable investment climate – as well as other causes of accelerated development – technological progress, flexible labor markets, and the institutional environment – which are far from perfect but, nevertheless, enable growth.

### **Human Capital and Technological Progress**

Many students of human capital are quick to refer to China's superior literacy rate. However, the higher literacy rate in China, including female literacy (87 per cent, compared with 45 per cent in India) is considered to be a legacy of the past. Despite the disruption caused by the Chinese social and economic experiments of the 1950s, 1960s and 1970s, the revolution did produce a literate population. At the same time, India boasts an advanced research community and highly sophisticated professionals, particularly in information technology (IT) and pharmaceuticals. While China's growth was driven by manufactured exports which exploited its skillful yet cheap labor, India is now relying on the human capital of its professional elite to move forward. According to Kripalani and Engardio, 'If India can turn into a fast-growth economy, it will be the first developing country that used its brainpower, not natural resources or the raw muscle of factory labor, as the catalyst' (2003, 70). Confirming the importance of human capital, the four case studies presented at GDN's 2006 conference – two from India (the software and space industries) and two from China (the automotive and personal computer industries) – have shown that it is possible for developing countries to catch up technologically with developed countries. Furthermore, both countries put great emphasis on skills development, not only as government policy, but also as a cultural practice deeply rooted in Chinese values as well as among India's upper castes (Altenburg, Schmitz and Stamm 2006, 30).

Dollar acknowledges China's historical advantage in terms of literacy, citing extensive data and studies by Christian Morrisson and Fabrice Murin (2005) as well as by Robert Barro and Jong-Wha Lee (2000): 'Already in 1870, 21 per cent of adults in China were literate – since nearly all of these would have been males, this means that about 40 per cent of adult males were literate. ... In 1990, even though China was poorer than India or RODA [the rest of developing Asia], it had a more educated population' (89). Dollar also points to another aspect of China's superiority in human capital – infant mortality data, that are a good summary indicator of health status: 'In 1990 China's infant mortality rate was 38 per 1,000, far below India's 80 or RODA's 69' (50).

Contemplating the relative terms of human capital development in the near and medium future, some scholars draw attention to India's 'demographic dividend'. China faces the non-enviable position of having become old (due to the aging population) before becoming rich. But India stands to benefit from the growth dividend of its young population (Kelly and Rajan 2006, 11). However, as Acharya notes, India's prospective advantage depends on the country's ability to educate the next generation (38).

Leaving the future aside, it is nevertheless China which today is successfully building on its human capital 'must transform from a growth model based on productivity advances from factor reallocation to one which is fuelled by technological advancement and innovation' (19). As indicated by Yueh in Chapter 1, 'The need to improve domestic productivity has led China to become one of the largest investors in research and development in the 2000s' (17). Human capital and technological progress, as signaled by the R&D expenditure, are thus widely used in China to stimulate the intensive growth which has become the country's trademark.

### **Labor Market Flexibility**

Radical reforms are usually painful. But they often produce unexpected means to adapt to change which, although not perfect, can partially relieve the pains and further drive development. Chapter 8 by Yang Du, Fang Cai and Meiyang Wang, in the second part of the book, discusses labor market informalization in China as a way to adjust to the process of dismantling of the communist-era employment system, known as 'breaking the iron rice bowl'. Informal employment has many disadvantages compared with formal employment, such as lower earnings, longer working hours, inadequate work conditions and the lack of social protection. But it is still better than unemployment and – due to its low costs, market dependency and flexibility in hiring and firing – it can increase labor mobility, create additional opportunities for investment and contribute to sustainable development.

Relying on China's Comprehensive Labor Statistics Reporting System and a household survey, Du, Cai and Wang show that informal employment has been growing in post-reform China. They provide evidence that the flexibility offered by informal employment has promoted a form of work which offers greater security than the existing social security system, even though this is not an excuse for neglecting state-sponsored social security. Informal employment has been the main path for developing a labor market in China, and allowing wage rates to be determined by the market is a key source of growth in this labor-abundant country. Equipped with their findings, these researchers caution the Chinese government that its zeal to further regulate the labor market could

destroy the informal sector's positive effects on job creation and poverty reduction. They also advocate enhancing education and providing training in order to gradually formalize employment, while preserving labor market flexibility.

## Openness

As noted by Dollar, the Chinese refer to their reform program as *Gai ge kai fang* which translates as 'change the system, open the door', while the whole reform program is often called the 'open door' policy. Having first welcomed foreign direct investment (FDI) into 'special economic zones', China has become the world's largest recipient of investment flows. Trade liberalization was another key component of Chinese reform: ... after joining the World Trade Organization China's average tariffs have dropped below 10 per cent, and to around 5 per cent for manufactured imports (52). Yueh also emphasizes the importance of China's outward-looking development model. 'For an economy of its size, China has a high degree of openness (70 per cent when measured as exports plus imports as a proportion of GDP), as compared with 37 per cent for the comparatively open United Kingdom and 20 per cent for the more closed United States' (3).

Writing about India, Acharya finds the same trend. The country's 'economy in 2006 is far more open to external trade, investment and technology than it was 15 years ago' (28). In Chapter 6 Mavannor Parameswaran similarly contends, 'India is moving from an import substituting and inward-oriented trade policy regime toward a more open and liberal trade policy regime' (120). These views are consistent with that of L. Alan Winters and Shahid Yusuf (2007, 9): 'China's trade expansion since 1978 has been legendary, and, since the early 1990s, India also has taken off.' Moreover, both countries have been the most attractive FDI destinations in the world – ahead of the United States (Kelly and Rajan 2006, 9).

But although China and India are similar in their drive toward openness, China is much ahead of India. 'China has done more to open its economy to the global market', Dollar notes, 'while significant numbers of its coastal cities have created sound investment climates for private investment. The result has been a remarkable growth dynamic. India has followed a similar path, but more slowly in terms of opening up the economy and with less success in creating good investment climates' (54). Acharya expresses this difference between the two countries even more emphatically, protesting, 'The prevailing fashion of bracketing India's rise with China's exceptionally dynamic development under rubrics like "China and India Rising" may mask more than it reveals' (41). Acharya's comparison of India's 'good' versus China's 'extraordinary'

development in the last 25 years largely hinges on his evaluation of the degree and pace of opening up their economies: ‘While India has been a gradual “globalizer”, China’s surging development has been far more intensively based on global trade and capital flows’ (41).

### **Trade Liberalization and its Impact**

Part 2 of the volume continues the focus on development, concentrating specifically on drivers of and barriers to development. Echoing Acharya, in Chapter 4 Choorikkadan Veeramani contrasts China’s dramatic opening up since 1978 with India’s ‘cautious liberalization’ launched in the 1980s and highlights such consequences of trade liberalization as the expansion of intra-industry trade<sup>2</sup> versus inter-industry trade.<sup>3</sup> This distinction is crucial, because if the intensity of intra-industry trade increases with the reduction of trade barriers, this would undermine a common argument that import liberalization leads to the demise of domestic industries in the developing countries. Also, intra-industry adjustment is associated with relatively low costs because it entails workers’ movement within industries rather than between them. Based on his research, Veeramani comes to the conclusion that by 2005 the manufacturing industries of China and India show roughly similar intensity of intra-industry trade. Growth of intra-industry trade reflects greater specialization in unique varieties and product lines by the individual plants in China and India, demonstrating that the large majority of domestic industries and firms in both China and India can successfully compete and survive under liberal trade regimes via specialization in narrow product lines. This finding gives ammunition to supporters of globalization, by providing empirical evidence that the elimination of trade barriers is consistent with developing countries’ interests.

While Veeramani discusses the impact of trade liberalization on China and India, Chapter 5 examines the sources of China’s export growth and analyzes how trade liberalization in China affects the rest of the world. Based on the detailed data on Chilean imports between 1990 and 2005, Roberto Álvarez and Sebastián Claro first show that China’s strong export penetration relative to other countries is mainly explained by an increase in the intensive margin; that is, an increase in the volume of exports in product categories which are also exported by other countries. Surprisingly, the main source of growth in the intensive margin is explained by an increase in exported quantities, without a significant fall in the relative price of Chinese products. One explanation for this apparent paradox is an increase in the willingness to pay for quality Chinese products relative to the rest of the world. Their study provides direct and indirect evidence of the growing sophistication of China’s export mix.

In particular, it demonstrates that exports from China have increased their similarity with exports from rich countries, and that the quality of Chinese exports has improved over time. The research findings confirm that product quality does indeed matter, and that it is an important dimension of Chinese export growth. They also corroborate Dani Rodrik's (2006) evidence that, given China's level of income per capita, the country has a sophisticated export mix because a high share of its exports corresponds to products mainly exported by high-income countries.

Parameswaran analyzes a very different type of trade liberalization impact – the effect on firms' R&D investment. This analysis adds to the debate on whether a more open trade policy regime accelerates the technological prowess and growth of an economy. Parameswaran shows that exporting firms have greater incentive to invest in R&D, suggesting that trade liberalization and the subsequent removal of the anti-export bias of the system can encourage innovation and technological progress. Moreover, he finds that the impact of import competition depends on the domestic market structure. Specifically, import competition promotes investment in R&D only in those industries where the market structure is highly concentrated; otherwise, it has a negative impact.

Thus, the study reveals the conditional nature of the impact of trade liberalization and thereby highlights the need for complementary policies to make domestic conditions favorable. To improve innovation and technological progress of the domestic industry, trade policy should be aligned with suitable industrial policy. In particular, industrial policy should help firms achieve a scale of operation viable for undertaking various productivity-enhancing investments. An example would be a removal of legal barriers on entry and exit and removing restrictions on the scale of operations, mergers and amalgamation, which would allow an industry to adjust to the liberal trade policy regime by increasing its technological standards.

The three empirical studies of the impacts of trade liberalization send the same message: liberal trade regimes can be beneficial to both developed and developing countries and to both exporters and importers. Moreover, countries' accomplishments – whether an improvement in product quality or meeting challenges of import competition – are generally well rewarded. However, taking advantage of trade under conditions of economic openness requires mastering the art of adjustment. Specialization in unique varieties and product lines may be an effective response to import liberalization. An improvement in product quality can go together with price reduction as a result of surging productivity. Finally, trade policy should be complemented with effective industrial policy to achieve innovation and greater productivity.

## FDI and Investment Climate

This book also discusses the factors responsible for the inflow of FDI into China and India, building on previous studies. China's foreign-investment boom is largely attributed to the power of the Chinese diaspora worldwide. Most investment comes to China from Hong Kong, Macau and Taiwan. This phenomenon is sometimes called 'China plus': China plus key neighbors and China plus multinational companies which have established their factories in the country (Schmitz 2007, 2). Compared with the Chinese, the Indian diaspora is much less connected to the homeland.

In Chapter 3 Dollar emphasizes that the 'opening up' measures had such substantial impact because they were accompanied by improvements in investment climate. Claiming that this is probably one of the least understood features of China's recent development, he refers to Chinese coastal cities which developed good investment climates which, in turn, catapulted the private sector into the leading sector of the economy and made it highly profitable. For example, while Indian firms lose 7.9 per cent of their output due to unreliable power supplies, the comparable figure for firms located in coastal Chinese cities is 1.0 per cent; while it takes an average of 6.6 days for imports to clear customs in India, it is only 3.2 days in Chinese cities (54). In general, there are fewer constraints on the private sector in China. For example, it takes 90 days to start a business in India, but only 30 days in China (Dollar, Hallward-Driemeier, Shi, Wallsten, Wang and Xu 2003, 3).

However, even though FDI is widely recognized as a driver of economic development, not all observers are euphoric about China's over-reliance on this channel. In his provocatively titled book, *Selling China*, Yasheng Huang (2003) argues that China's reliance on FDI reflects the huge deficiencies and lower competitiveness of its corporate sector. While India receives little FDI, it has cultivated impressive entrepreneurship within leading global companies such as Infosys, Wipro and Tata Consultancy Services.

Another paradox is that China's incredible economic openness is not supported by political openness. This mismatch, due to the country's authoritarian (closed and strongly regulated) political system, may jeopardize the sustainability of China's development in the long run. Conversely, India is an open society in the political sense, but it displays limited economic openness. The question about the relative importance of economic (FDI and trade) versus political openness (democracy and freedoms) as drivers of development naturally raises the issue of institutions.

## Institutions

Thanks to reforms the general institutional environment in both countries is improving, although they still leave much to be desired. The courts are slow and corruption is rampant in China as well as India. Both China and India ranked 70th on the 2006 Transparency International Corruption Perceptions Index, while the 'cleanest' nations included Finland, Iceland and New Zealand. Private property rights are not sufficiently protected in China, and in India, contracts are not always enforced, ownership of land is often unclear and the bureaucracy is slow.

Some observers, nonetheless, claim that the 'soft' infrastructure of institutions, including legal institutions, is better in India. Questioning the image of India lagging behind China, Huang and Khanna (2003, 78) write: 'Although India's courts are notoriously inefficient, they at least comprise a functioning independent judiciary. Property rights are not fully secure, but the protection of private ownership is certainly far stronger than in China. The rule of law, a legacy of the British rule, generally prevails'. Furthermore, while China has no institutional framework for managing dissent, India is considered to be a 'messy democracy', and its government does not interfere much in private sector activities apart from providing a regulatory framework. As a result, home-grown entrepreneurship flourishes in India, while China 'has imposed substantial legal and regulatory constraints on indigenous, private firms' (Huang and Khanna 2003, 76).

Chapter 10 by Yan Shen and Yang Yao challenges the near consensus that China lacks democratic institutions. The authors focus on the country's grassroots democracy, that they interpret as 'a significant milestone in China's progression toward a full democracy' (243). In 1987, the National People's Congress (NPC) passed a tentative version of the Organic Law on the Village Committee, that started a ten-year-long experiment with village elections. In 1998, the NPC formally passed the law and elections quickly spread throughout the whole country. Yan and Yao admit, 'The elections hardly take place in a friendly institutional environment' (225). Within the village, the authority of the elected village committee is seriously constrained, if not superseded, by the Communist Party committee. Outside a village, the township and county governments still maintain a heavy hand in village affairs. Also, the decentralized nature of the election may make it easier for local elites to capture local politics. Nevertheless, based on survey data, the researchers come to the striking conclusion that despite all constraints on village democracy, such interference actually improves accountability and income distribution in the community. This finding has significant policy implications for the current debate on China. First, it shows that grassroots democracy can work even

in a distorted institutional environment. Second, villagers can quickly learn how to run a functioning democracy and steer it toward serving their interests. Third, the reduction in income inequality can be achieved through the villages' pro-poor actions, such as increasing productive investments. The Chinese experience thus defies the conventional wisdom that democracy necessarily leads to policies focused on redistribution.

Yan and Yao's conclusions challenge Acharya's contention that democratic populism is a significant source of fiscal stress. Referring to the advent of India's United Progressive Alliance government in 2004 and its populist expenditure programs, such as the National Rural Employment Guarantee scheme, Acharya asserts that 'the possibility of significant public pay increases [and, as a result, fiscal pressure] is obviously high' (35). The difference in the perceptions between Yan and Yao, on one hand, and Acharya, on the other, may be due to the difference in the focus of their analysis – the small-scale village elections versus national democracy. Yan and Yao maintain, 'Within the village context of lineage and other intimate ties, it may be easier for the villagers to reach more productive decisions than to fight for more short-term redistribution' (244). In contrast, large-scale democracies are inevitably less flexible and less mobile and, as a result, have to resort to manageable 'short cuts', such as arbitrary pay raises and income redistribution schemes to satisfy their constituencies.

Similar to the lack of agreement on the fiscal implications of democracy, the impact of democracy on development also remains a contentious issue. Theoretically, democracy is beneficial for development (see, for example, Sen 1999). But the empirical evidence to support this assertion is scarce, leading Dollar to conclude: 'In developing Asia there is no clear relationship between political systems and good economic governance' (57–58). Dollar goes on to elaborate his point:

Leaving developed countries out of the analysis, there is no correlation between democracy as measured by Freedom House and ICRG's [International Country Risk Guide] property rights/rule of law index ... In the very long run there is likely to be a relationship – all the fully industrialized countries have both good economic governance and liberal democracy. But the lack of correlation between democracy and economic governance among developing countries suggests that the relationship is a long-run one, and probably a complex one with causality running both ways (58).

This mixed evidence about institutions confirms the major finding of the previous book in the Global Development Network Series, *Political Institutions and Development* (Dinello and Popov 2007), that highlighted the

failed expectation that there is one optimal institutional design which can be successfully applied to any country. Based on macro- and micro-level studies, *Political Institutions and Development* showed that institutions are highly context-dependent and time-sensitive and must be tailored to local conditions. Consistent with this understanding, China and India may require quite different institutional designs to resolve similar problems, such as corruption, insufficient protection of property rights and slow bureaucracy. Both Indian-style ‘messy democracy’ or Chinese-style gradual democratization, starting with village elections, should build on local advantages and be effectively customized to meet the existing challenges and further promote development.

## BARRIERS TO DEVELOPMENT AND CHALLENGES AHEAD

When assessing China’s and India’s recent development and its sustainability, skeptics tend to focus on existing limitations on growth. Some of these challenges are short-term (for example, infrastructure bottlenecks for India, trade imbalances for China, the international economic environment for both); some medium-term (resource scarcity, environmental degradation and growing inequality); and others are structural (i.e., cozy relations between state and business). The analysis of limitations included in this book does not necessarily apply to both countries. But the collection of studies gives an overall sense of the factors which weaken these countries’ economic growth and endanger their social development.

### Short-Term Limitations

In Chapter 2 Acharya writes extensively about the ‘legendary problems’ of India’s infrastructure; issues which reflect failures in public sector performance and governance. Referring to World Bank data, he indicates that over 60 per cent of Indian manufacturing firms own generator sets (only 27 per cent in China), and India’s combined real cost of power is almost 40 per cent higher than China’s. The quantity and quality of roads is also a serious choke point. While there has been some progress in recent years with national highway development, state and rural road networks are woefully inadequate, especially in poorer regions. Urban infrastructure, especially water and sewerage, is another major constraint for rapid industrial development and urbanization (35).

Compared with India’s creaking seaports, airports, roads and power supplies (Kelly and Rajan 2006, 9–10) China has considerable physical infrastructure (in particular highways, telephone service and energy supply). At the same

time, China's 'institutional infrastructure' – such as the banking, legal and judicial systems – is frail. Yueh maintains that China has 'weak formal institutions, particularly those required to support contracting and to reduce the risk of appropriation' (11). Nevertheless, China, with its exceptional economic growth, has relatively more resources to address this weakness. As noted by T.N. Srinivasan (2004, 7), 'The potential budgetary impact of addressing the non-performing loans of state-owned banks in India is more serious than in the case of China because of the better fiscal health of China'.

In the immediate future, the trade imbalance between China and the United States is a real worry. The current situation is not sustainable, and China needs to shift its production away from exports and toward internal needs such as better social services and higher household consumption. Dollar is quite categorical in outlining possible consequences of the trade imbalance: 'If the two countries do not cooperate on resolving the trade imbalance through higher savings in the United States and greater consumption in China (including public spending on health and education), there could be a nasty global recession with high US dollar interest rates and sharply falling commodity prices, that would create a very poor environment for the rest of the developing world' (48–49).

Moreover, although the international economic environment has been so far favorable to the development of China and India, its preservation is not guaranteed, and there can be negative consequences for both China and India if this environment deteriorates. Focusing on consequences for India, Acharya writes: 'The chances of some slackening in the growth of world output and trade are clearly rising. Just as the Indian economy has benefited from strong global expansion in the last four years, so it may expect to bear some downside risks from slower world growth in the years ahead' (39).

### **Medium-Term Limitations**

Many observers believe that strong economic growth in China and India puts heavy pressure on global natural resources and significantly increases environmental pollution (Winters and Yusuf 2007, 16; OECD 2005). Dollar describes the related concerns about impending resource scarcity and deterioration of the environment in relation to China. He points to the very high rates of resource consumption by the Chinese economy: 'Over the past 15 years China's oil imports have been growing rapidly ... and [the country] has emerged as the second-largest importer behind the United States. Before long it will emerge as the largest importer' (61). He also highlights the country's incredible inefficiency in the use of resources, particularly energy. High resource consumption, compounded by their inefficient use has resulted in high levels of pollution, especially air pollution. Considering these unfortunate

circumstances, Dollar predicts, 'In the medium term, the resource-intensity of China's growth is not sustainable' (47).

Growing inequality is another medium-term challenge facing China. Although China has achieved the most rapid poverty reduction in human history over the last 30 years, that trend has begun to reverse in recent years, raising concerns about whether the country's future transformation would be balanced. The rural–urban differences are the most obvious dimension of inequality in China, in fact ranking as one of the worst in the world for this indicator. Another important dimension is the large gap between coastal and interior provinces. While the rural–urban differences fuel massive migration from the countryside to cities, the regional disparities boost migration across the country. Already about 200 million people have relocated. In the next 10–15 years, another 200 million will likely follow suit. Such migration may be a source of growth as people move from lower- to higher-productivity employment, but it is an enormous challenge to ensure that migration on such a gigantic scale proceeds smoothly.

On top of rural–urban and regional disparities, there are also growing inequities within the countryside and among urban residents. As Dollar admits, China's Gini coefficient (0.41) is not high compared with larger Latin American countries (Brazil's Gini coefficient is 0.58 and Mexico's is 0.50). But still the rapid recent increase in inequality is a real concern. Due to inadequate public expenditure, 'China, ironically, has one of the most privatized health care and education systems in the world in which the majority of expenditure is paid for privately, out of peoples' pockets' (63). This, in turn, results in slower social improvements (for example, a slower decline in infant mortality) than expected. The top political leadership in China has recognized this problem, that is reflected in Beijing's current focus on developing a more 'harmonious society'.

Compared with China, social development in India is even more difficult, as there are fewer resources to invest due to lower rates of economic growth. Consequently, many social services have crumbled. Approximately 29 per cent of India's population (almost 300 million people) live below the poverty line and depend on free health services from the public sector. But as shown by Raman and Björkman in Chapter 7, deficiencies in India's public health system force the poor to seek services from the private sector, that has grown remarkably. Based on 16 case studies of public–private partnerships in nine states of India, Raman and Björkman find that if well designed and implemented in stages, public–private partnerships have proven to be an innovative mechanism to deliver health services to the poor. However, given current limitations, the public sector must build capacity within its own institutions in order to optimize the benefits of partnerships. They also contend that while it is unfair

to describe such partnerships as ‘privatization’, they are no substitute for more efficient governance of the public sector health system.

The overall quality of health services in India leaves much to be desired. Acharya notes that the staff in primary health clinics in many Indian states are not as competent as their counterparts in other developing countries, such as Tanzania and Indonesia (39). Policies and programs for education and skills development are yet one more weak spot for India. Even though school enrolment rates have climbed over time, the actual cognitive skills acquired in schools (even simple reading and arithmetic) are still very low (Pratham 2006). Government-led programs in critical social sectors suffer from the lack of reform impetus. Unless health care and education are significantly improved, India will not be able to retain its competitive edge in an increasingly globalized, knowledge-based world economy.

India’s feeble agriculture sector constitutes another serious drag on the economy. As Acharya points out, ‘The share of agriculture in GDP has declined to hardly 20 per cent. But agriculture is still the principal occupation of nearly 60 per cent of the labor force. Thus improving the performance of this sector is essential to alleviate poverty and contain rising regional and income inequalities’ (38). However, since the mid-1990s, the growth of agriculture has dropped to barely 2 per cent, compared with earlier trend rates ranging between 2.5 and 3.0 per cent. There are many reasons behind this frailty, including ‘declining public investment by cash-strapped states, grossly inadequate maintenance of irrigation assets, falling water tables, inadequate rural road networks, unresponsive research and extension services, soil damage from excessive area use (encouraged by high subsidies), weak credit delivery and a distorted incentive structure which impedes diversification away from food grains’ (37). To revitalize agriculture, India needs greater investments in (and maintenance of) rural infrastructure such as irrigation, roads and soil conservation, and it must reinvigorate the present systems of agricultural research and application. These are difficult tasks for India’s state governments, given their weak financial and administrative capabilities.

### **Structural Challenges**

Yueh regards the ‘close relationship among the state, state-owned enterprises and state-owned banks’ as ‘the core of the structural problems in China’s transition path’ (3). This coziness manifests itself at the national as well as the provincial level. The state’s deep involvement in the economy – i.e., soft budget constraints due to refinancing of loss-making enterprises – undermines firm discipline and contributes to their inefficiency.

Continuing the theme of improper relationships between state and business, in Chapter 9 Wubiao Zhou confirms that many Chinese entrepreneurs are eager to obtain a political position in order to promote their enterprises. Membership in China's People's Congress (PC) and People's Political Consultative Conference (PPCC) are among the most attractive positions for private entrepreneurs, because they carry with them substantial legitimacy and social capital benefits. Based on the 2000 National Survey of Chinese Private Enterprises, that includes data on more than 3,000 private firms from all 31 Chinese provinces, Zhou's study suggests that even though the PC and PPCC have little real political power and simply endorse Communist Party decisions, memberships in these bodies can facilitate access to bank loans for private entrepreneurs. This is very important because the private sector, especially small- or medium-sized private firms, have great difficulties securing loans from China's state-owned or state-regulated banks.

The research on financing China's entrepreneurs is part of a broader debate on how state-business coziness affects economic development. Zhou demonstrates that because of the unfriendly regulatory environment, Chinese entrepreneurs have resorted to political strategies and networks to resolve their financing problem. Such entrepreneurial political behavior may involve rent seeking and corruption. The competition among entrepreneurs for legislative posts creates opportunities for local party officials to extract bribes from competitors. Corruption may also emerge when an entrepreneur uses high-status contacts to establish relationship lending or to intervene in bank credit decisions. Nevertheless, Zhou is less straightforward than Yueh in characterizing this phenomenon as purely negative. He makes a distinction between the consequences of state-business coziness in the short and long run and argues that his findings provide some support to the view that corruption may serve as temporary grease for the wheels of commerce. However, in the long run state favoritism discourages many other private entrepreneurs and will inevitably constrain economic development.

Finally, the book focuses on India's labor market rigidities as enormous structural obstacles. In the last 20 years the country's labor force has grown to more than 400 million people. Yet India's non-agricultural employment in the private organized sector (units employing more than 10 workers) has stagnated below 9 million people. Acharya faults India's complex and rigid labor laws, perhaps the most restrictive labor laws in the world, which impede 'firing and hiring' (35–36). These laws, while protecting those with organized sector jobs, strongly discourage new employment in the formal sector. 'Without significant reform of existing labor laws', he writes, 'India's cheap labor advantages remain hugely underutilized' (36). This also poses a political challenge because

the bulk of the country's forthcoming 'demographic dividend' will occur in the poor, slow-growing and populous states of central and eastern India.

\* \* \*

This volume's cross-country comparison of drivers of and barriers to growth reveals similarities as well as differences between China and India. In terms of drivers, both states rely on research as an important factor of development, have considerably opened their economies to international trade and foreign investment, and have made efforts to improve their institutional environments. China, however, is much ahead of India in terms of literacy and other indicators of human development and has achieved record exports and attracted record FDI. On the other hand, India enjoys a 'demographic dividend' and the exceptional brainpower of its research community. It also has a better 'soft' institutional infrastructure, due to the country's long legacy of democracy and respect for the rule of law.

At the same time, both countries face serious limitations in their development. Regarding India, this book highlights the 'legendary' bottlenecks in its 'hard' infrastructure and low quality, high-cost health services. China's development is troubled by an enormous trade imbalance with the United States and grave concerns about the inefficient use of resources and environmental degradation. Both China and India are plagued by inefficient social sectors and high, increasing social inequality. The only limitation on India which is not characteristic of China is its labor market rigidity. Instead, China benefits from labor market flexibility, that promotes employment and fuels growth.

Depending on the combination of stimuli and constraints on development as well as their relative intensity, evaluations of these countries' progress range from euphoric to disparaging. An impression of the 'glass half-full' more often refers to China than India. Although there are common weaknesses, China is usually viewed as a greater achiever, that also boasts vaster resources to resolve existing bottlenecks. The final judgment has, however, many sources and many facets. And it is these numerous ingredients of success versus failure – and their delicate balance – that will interest readers of this book.

## NOTES

1. As evidence of this extraordinary growth, for example, China's per capita income doubled in only 10 years following 1978, while the United States' per capita income doubled in 50 years following 1840.
2. Refers to the simultaneous presence of imports and exports of the products of a given industry.
3. Refers to export increase from one set of industries and import increase in another.

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