Presentation of the book

"Over the last few years the media, particularly the financial press, have been all agog over the rise of China and India in the international economy. After a long period of relative stagnation, these two countries, containing nearly two-fifths of the world population, have had their incomes growing at remarkably high rates over the last quarter century or so. In 1820 these two countries contributed nearly half of world income; in 1950 their share was less than one-tenth, currently it is about one-fifth, and the projection is that in 2025 it will be about one-third.

India was slightly ahead of China in 1870 as well as in the 1970's in terms of the level of per capita income at international prices, but since then particularly since 1990, China has surged well ahead of India. India's per capita income growth rate in the last two decades has been nearly 4 per cent, China's has been at least double that rate, and even discounting for some overstatement in the Chinese official rates of growth, the rate of growth in China has been significantly faster. In the world trade of manufacturing, China, and in that of services, India, have made big strides, much to the (as yet largely unfounded) consternation of workers and professionals in rich countries. Apart from attracting substantial foreign investment to their own large domestic markets, global companies originating from these two countries have started flexing their muscles in acquiring companies in Western markets. Journalists have referred to the economic reforms and integration of these large countries into the world economy in all kinds of colorful metaphors: giants shaking off their 'socialist slumber', 'caged tigers' unshackled, etc. Newspaper columnists and media pundits have sent breathless reports from Beijing and Bangalore about the imminent and inexorable competition from these two new whiz kids in a hitherto complacent neighborhood in a 'flattened', globalized, playing field. Others have warned about the momentous implications of 'three billion new capitalists', largely from China and India, redefining the next phase of globalization.

While I believe there is some amount of exaggeration in this build-up and in the supposed difficulty of the rich countries to cope, this book is *not* about the large challenges that China and India pose for the rest of the world either in economic or geo-political terms. It is more an attempt to look inside these two countries and carry out a comparative assessment of their economic achievements and their still massive problems, with the focus on structural and institutional issues in the domestic political economy context.

For about 100 years before Liberation in China in 1949 and for about 200 years before Independence in 1947 in India the encounter of these two countries with the international powers has not been altogether pleasant. There are disputes among historians about how much of the economic stagnation and relative decline in this period is due to that encounter. But there is no dispute today that the rise of China and India, and the (partial) restoration of their earlier important place in the world economy within a rather short span of time (a little over a quarter century) has been one of the most striking phenomena in recent history in the international economy. To explain this phenomenon it has been common to use a set of simple generalizations that seem to have now become part of the 5 conventional wisdoms. The familiar story runs on lines briefly described in the following two paragraphs:

Many decades of socialist controls and regulations stifled enterprise in both countries and led them to a dead end. Their recent market reforms and global integration have finally unleashed their entrepreneurial energies. Their energetic participation in *globalized capitalism has brought about high economic growth in both countries, which in turn led to a large decline in their massive poverty. The two countries are now full of billions of 'new capitalists' striving to find their place in the sun. While the Indian performance in this respect has been substantial, it has been overshadowed by the really dramatic performance of China. China's explosive industrial growth in the last quarter century is hailed as historically unique, even better than the earlier East Asian 'miracles'. Like those 'miracles', China's is often regarded as another successful story of a 'developmental state', with an active industrial policy and state – financed and – guided program of industrialization.*

China's better performance than India's suggests that authoritarianism may be more conducive to development at early stages, as we have seen earlier in South Korea, Taiwan, and Singapore. In the Chinese case, however, regional economic decentralization provided some dispersal of power and more autonomy and incentives to local people, and even without democracy it led to broad – based local development (unlike in Russia where regional decentralization led to collusion between local governments and oligarchs, only recently curbed by a semi – authoritarian and centralized Putin administration). Global capitalism, however, has inevitably brought rising inequalities, more in China than in India, and this may portend some problems for the future political stability in China, as it does not have the capability of democratic India to let off the steam of inequality – induced discontent. But all is not lost for democracy in China. The prospering middle classes will demand more democratic rights and usher in democratic progress in China, as they have in South Korea and Taiwan.

There are, of course, elements of truth in this story, but through constant repetition it has acquired a certain authoritativeness which it does not deserve under closer scrutiny. Much of this book challenges different parts of this oversimplified story.

Take the oft-repeated point that it was global integration that brought about high income growth, which then brought down the extreme poverty that had afflicted China and India over many decades, even centuries. China had major strides in foreign trade and investment mainly in the 90's and particularly in the subsequent decade. But already between 1978 and 1993, before those strides, China had a very high average annual growth rate of about 9 per cent. As we show in Chapters 2 and 7, much of the high growth in the first half of the 80's and the associated dramatic decline in poverty happened largely because of internal factors, not globalization. These internal factors include an institutional change in the organization of agriculture, the sector where poverty was largely concentrated, and an egalitarian distribution of land cultivation rights which provided a floor on rural income earning opportunities, and hence poverty alleviation.

While expansion of exports of labor-intensive manufactures lifted many people out of poverty in China in the last decade or so, the same is not true for India, where exports are still mainly skill- and capital intensive. It is not completely clear how economic reform is mainly responsible for the recent high growth in India. Reform has clearly made the Indian corporate sector more vibrant and competitive, but most of the Indian economy is not in the corporate sector, with 94 per cent of the labor force working outside this sector, public or private. Take the fast-growing service sector, where India's IT-enabled services have made a reputation the world over, while employing less than one-third of one percent of the total Indian labor force. Service sub-sectors like finance, business services (including those IT enabled services) and telecommunication, where reform may have made a significant difference, constitute only about a quarter of the total service sector output. Two-thirds of this service output is in traditional or “unorganized” activities, in tiny enterprises often below the policy radar, unlikely to have been directly affected substantially by the regulatory or foreign trade policy reforms.

As for poverty in India, the latest household survey data suggest that the rate of decline in poverty has not accelerated in 1993-2005, the period of intensive opening of the economy, compared to the 70’s and 80’s, and that some non-income indicators of poverty like those relating to child health, already rather dismal, have hardly improved in recent years. The growth rate in the agricultural sector, where most of the poor are, has declined somewhat in the last decade, largely on account of the decline of public investment in rural infrastructure , which has little to do with globalization. Also, those who envisage ‘billions of new capitalists’ in China and India do not realize that hundreds of millions of poor people in either country are currently scrounging a living from tiny family enterprises of extremely low productivity, and they don’t have the kind of access to credit, marketing, and infrastructure or the basic skills and education and risk-bearing capacity that can make a capitalist enterprise possible. They are there because the capitalist parts of the economy (under state or private auspices) cannot absorb them.

All this is not to suggest that economic reform and global integration have not been important in China or India or that there has not been some unleashing of entrepreneurial energies in recent years; my plea is only to suggest looking more into the complex interaction of markets with the forces, positive and negative, that affect the lives of the poor.

China and India have now become poster boys of market reform and globalization in parts of the financial press, even though in matters of economic policy toward privatization, property rights, deregulation and lingering bureaucratic rigidities both countries have demonstrably departed from the economic orthodoxy in many ways. This, however, has not escaped the attention of the Heritage Foundation. If one looks at the figures of the Index of Economic Freedom 2008 released by the Foundation, the ranks of China and India are quite low; out of a total of 157 countries China’s rank is 126th and India’s 115th , both are relegated to the group described as “Mostly Unfree”, in a position much worse than many “Moderately Free” countries in Central and South America. Of course, not many have pointed out that the economic (particularly growth) performance of these two “Mostly Unfree” countries in terms of economic freedom seems to have been much better than that of most others.

While there is no doubt that the period of socialist control and regulations in both countries inhibited initiative and enterprise, it will be a travesty to deny the role of the positive legacy of that period, particularly in the pattern of state-controlled capitalist growth in China in recent years.

It is arguable that the earlier socialist period in China provided a good launching pad in terms particularly of

• a solid base of minimum social infrastructure (broad-based education and health) for the workers;
• a highly egalitarian land redistribution, which provided a minimum rural safety net, that eased the process of market reform in the initial years, with all its wrenching disruptions and dislocations;

• a system of regional economic decentralization (and career paths of Party officials firmly linked to local area performance)-- for example, county governments were in charge of production enterprises long before economic reforms set in and, more importantly, the production brigades of the earlier commune system evolved into the highly successful township and village enterprises that led the phenomenal rural industrialization
• large female labor participation and education which enhanced women's contribution to economic growth.

In all these respects China's legacy of the earlier period has been much more distinctive than that in India. When I grew up in India I used to hear leftists say that the Chinese were better socialists than us, now I am used to hearing that the Chinese are better capitalists than us. I tell people, only halfflippantly, that the Chinese are better capitalists now may be because they were better socialists then!

Another part of the legacy of the earlier period in both countries is the cumulative effect of the active role of the state in technological development. It is often overlooked that Chinese success in the international markets is not just in labor-intensive products like garments, toys, shoes and wigs. Both China and India (but China much more than India) has succeeded in the exports of products more sophisticated than is usually expected from countries in their respective per capita income range. This is remarkable and is primarily due to a sizeable skill and technological base in both countries, enriched over the 'slumbering' years by indigenous learning by doing, and nurtured by government policies of building domestic capabilities, sometimes at the expense of static efficiency of resource allocation emphasized in traditional theories of comparative advantage. Take auto parts, for example. Protection of 'local content' (of components) in automobiles, which is contrary to the orthodox trade policy prescription, was practiced in both countries, enabling their workers to learn the skills and reach international best-practice now. There are, of course, many other cases where protection from foreign competition sheltered massive inefficiency. There are also many cases of lingering government failures, say in financial intermediation in China or social service delivery in India.

While there are recognizable elements of industrial policy and 'developmental state' in the case of China, we point out in Chapter 6 crucial qualitative differences from the other East Asian cases: in contrast to the coordinated capitalism of Japan and South Korea (where the state presided over the coordination among private business conglomerates), the Chinese case can be, and has been, more aptly described as one of state-led capitalism from above and network (*guanxi*) capitalism from below to fit in the conditions of much weaker development of large private business in China; industrial policy has also been more diverse and diffuse in the context of regional variations and decentralized development in a continental-size economy; and foreign investment has played a more important role in technological upgrading and international marketing than in the other East Asian countries.

The much more dramatic growth success of China compared to India (and of other East Asian countries earlier, under authoritarian regimes) does not in any way prove the superiority of authoritarianism over democracy in development, as we discuss in detail in Chapter 10. We shall try to establish our claim that authoritarianism is neither necessary nor sufficient for development, and that the relationship between democracy and development is actually much more complex than is allowed in the standard discussion. Nor can one depend on the prospering middle classes to be sure-footed harbingers of democracy in China. In many cases the Chinese political leadership has succeeded in co-opting the middle classes (including the intelligentsia, professionals and private entrepreneurs) in its firm control over the monopoly of power, legitimized by economic prosperity and nationalist glory. Indian democracy derives its main life force from the energetic participation of the poor masses, not so much the middle classes.

China is widely, and rightly, acclaimed as a case of decentralized development, where in the 80's and 90's local industries under the control of local governments and collectives flourished. This is an aspect of industrialization that has largely bypassed India so far, even though important constitutional changes favoring devolution of power to local governments were carried out in the 90's. But it is not widely known that with fast economic growth, and with local Party officials prospering in a reward system that emphasized their local economic performance (with access to profits of local collective enterprises and the power to privatize them), the central government in China is now finding it difficult to rein in these local officials, particularly in matters of land acquisition (often in cahoots with local commercial developers), environmental degradation and violation of consumer product safety regulations (often in collusion with local business). The chanting of the mantra of 'harmonious society' by the central leadership has not yet been successful in curbing the capitalist excesses of local business and officialdom. The centralization of tax reform since 1994 has reduced the incentives (and capacity) of the local bureaucracy to serve social needs, particularly in interior provinces, and central transfers so far have not been adequate to compensate for this. The lack of democratic accountability mechanisms is and will be particularly felt by the local people both in the type of economic growth pursued and the delivery of social services. Thus China's vaunted regional decentralization, without democratic devolution, may now be a source of much discontent and may undermine the future sustainability of the economic growth it has fostered earlier.

On discontent a part of the conventional wisdom in the media as well as in academia is how (a) globalization has led to rising inequality and (b) the inequality-induced grievances, particularly in the left-behind rural areas of China, cloud the horizon for the future of Chinese polity and hence of economic stability. Since the effect of globalization on inequality is difficult to disentangle from that of other on-going changes (for example, those of skill-biased technical progress due to new information and communication technology), the causal link between globalization and inequality is not always firmly established. Moreover, in China, provinces with more global exposure and higher growth did not have the larger rise in inequality, compared to the other provinces in the interior. The decline in agricultural growth in recent years in both China and India may also have something to do with the rise in aggregate inequality, independent of globalization. It should also be noted that the widely accepted statement in the media that inequality is larger in China than in India needs to be qualified. First of all, the usually cited data for China refer to income inequality, whereas it is often overlooked that the Indian figures relate to inequality of consumption expenditure (which in most countries are usually lower than inequality of income). Secondly, inequality of income or consumption refers to inequality of outcome; the more relevant issue is that of inequality of opportunity, which in these poor agrarian economies is more often reflected in inequality of land and education. We'll show in Chapters 3 and 7 that inequality of land and education is substantially higher in India than in China. Thirdly, the usual income inequality figures do not correct for price differences across rural and urban areas and across regions; once corrected, the Chinese inequality of income is somewhat lower than the usually cited figure (in Chapter 7 we cite evidence that if one takes into account cost of living differences between rural and urban areas and across provinces, the national Gini coefficient of income inequality in China increased from 0.29 in 1990 to 0.39 in 2004).

The relation between inequality and social discontent is also rather complex. We cite some evidence from China in Chapter 10 that the presumed disadvantaged rural people are not particularly upset by the rising inequality. Rural people are often inflamed more by land seizures and toxic pollution than by inequality as such. Paradoxically, the potential for unrest may be more in the currently booming urban areas.

In this book we discuss these and other aspects of the political economy of China and India in more detail and try to indicate in general that the story of their rise is more complicated and nuanced than is made out to be in the standard accounts endlessly repeated in the media."