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The People's Republic of China (PRC) has achieved impressive economic growth over the past two decades. In recent years, India has also shown promising signs of economic acceleration. Despite this, both countries still remain poor. A critical question that continues to face them is whether they can sustain strong economic growth. This brief aims to shed light on this question by comparing and contrasting their economic performance and policies.

The PRC and Indian experiences demonstrate a clear correlation between reforms and economic performance. Overall, the PRC's higher growth is a manifestation of its more comprehensive and faster reforms, while the Indian experience sheds light on effective reform of service sectors. In both countries, policy and institutional reforms were rooted in their initial conditions. A characteristic of reforms in the PRC was the willingness to experiment in arriving at unorthodox solutions.

Economic Reforms and Economic Performance

The PRC's centrally planned economy between 1949 and 1979 featured comprehensive state control. Despite high annual investment growth of 9.6% achieved at the expense of consumption, GDP grew at an annual average of 4.8% from 1961 to 1977. While high investment initially lifted growth in the PRC, its growth rate was trending downward by the 1970s.

India had a "mixed" economy with a significant part of the economy belonging to the private sector. However, economic life was tied up in a stifling license system—the license *raj*. The average annual rate of real GDP growth from 1951 to the beginning of the 1980s was a lacklustre 3.6%, famously described as the "Hindu" rate of growth.

Both the PRC and India have adopted major reforms over the past two decades. Their reforms have focused on allowing the market to play a more important role by increasing both the openness of the economy to foreign trade and investment, and stronger participation of the nonstate-owned sector. Reforms in the PRC started in 1978. In India, some reforms were initiated in the 1980s. These were limited and undertaken in a low-key manner, thus earning the name "reform

by stealth.” In 1991, a balance of payments crisis prompted India to initiate wide-ranging reforms.

The PRC reforms brought about a sharp acceleration in economic growth. Average GDP grew by 9.5% from 1980 to 2003. Reforms also saw India throw off its Hindu rate of growth. Growth for the 1980s edged up to over 5.5%, and 6.0% from 1992 to 2003.

Economic growth has delivered significant benefits to the poor in both countries. From 1981 to 2002, the number of people living under the \$1 a day declined from 434 million to 357 million in India, and from 789 million to 203 million in the PRC (ADB 2004).

India Lags behind the PRC in Agricultural and Industrial Reforms

While India’s “Hindu rate of growth” may be a thing of the past, it still lags behind the PRC in many economic indicators (Table 1).

The differences can at least partly be attributed to the pace and coverage of reforms. Reforms in the PRC since 1978 made a defining change of direction from a Soviet style centrally planned closed economy model to the progressive adoption of the East Asian market-oriented open model of the newly industrializing economies.

For a long time, the PRC pursued a strategy of developing heavy industries at the expense of agriculture and labor-intensive industries. An important aspect of the PRC’s reforms was reducing the bias against agriculture and labor-intensive industries, thus allowing its comparative advantage, abundant labor supply, to be unleashed. Three aspects are noteworthy.

First, reforms enabled rural areas to reap significant benefits from this change of direction by granting peasants some control over farm output, labor, and land.¹ Rural reforms started with the dismantling of communes, introducing a household responsibility system, and reducing mandatory deliveries of output to the state, thereby enabling farmers to produce for the market. Changes in the procurement system greatly improved the agricultural terms of trade. Reforms have also improved the mobility of farmers, as many were able to work on other sectors and migrate to cities to seek better opportunities. This has not only lifted overall GDP growth, but also significantly reduced rural poverty.

¹ Land in the PRC is owned by the government but leased to farmers who have gained increasing freedom in allocating its use.

Table 1. **Economic Indicators**

Indicators	Definition	PRC	India
GDP growth	Annual average, 1980-2003 (%)	9.5	5.7
GDP per capita growth	Annual average, 1980-2003 (%)	4.0	7.0
GDP per capita	1980 (US\$)	264	192
	2003 (US\$)	563	1094
Population living below the PPP 1\$ a day	2002 (% of population)	15.9	34.0
Industrial growth	Annual average, 1980-2003 (%)	11.4	5.9
Manufacturing growth		10.9	6.4
Share of industry	2003 (% of GDP)	52.9	22.7
Share of manufacturing		35.4	16.3
Agricultural growth	Annual average, 1981-1995 (%)	5.6	3.2
	Annual average, 1996-2003 (%)	3.2	2.7
Share of agriculture	2003 (% of GDP)	14.8	25.7
Service sector growth	Annual average, 1980-2003 (%)	8.4	7.4
Share of services	2003 (% of GDP)	32.3	51.6
No. of people living below \$1 a day	1981 (million)	789.1	434.3
	2002 (million)	203.2	356.8
Average tariff rate	2003 (%)	12.0	30.0
Global trade share	1980 (%)	0.9	0.4
	2003 (%)	5.7	0.8
Foreign direct investment	2003, US\$ billion	53.5	4.3

Sources: ADB (2004), World Bank (2004).

Second, the rural reforms facilitated gains in the industrial sector by giving rise to a uniquely PRC phenomenon—the birth of dynamic township and village enterprises (TVEs). The booming of TVEs was supported by increased agricultural productivity that released a large supply of surplus labor. It was also associated with rising rural incomes that injected capital required to set up these enterprises. TVEs have not enjoyed much government protection and were subject to market competition and hard budget constraints, but have the freedom to operate outside state planning.

TVEs played an important role in economic growth from the early 1980s to the late 1990s. The booming TVEs resulted in the surge of labor-intensive industries. The share of TVEs in industrial output rose from 9% in 1978 to 58% in 1997. The number of workers employed in TVEs increased from 28 to 135 million over the same period (Lin and Yao 2001). From 1980 to 2003, the overall industrial sector grew at an annual average rate of 11.4%. Industry currently accounts for about 53% of GDP and produces 92% of total exports.

The PRC experience of agricultural reforms demonstrates that mainstreaming farmers into the growth process typically works better than distribution-oriented strategies. The growth of agriculture and labor-intensive industries has in particular helped to lift income and generate employment opportunities for the poor. It also demonstrates the close relationship between agricultural and industrial growth. Agricultural growth has provided the vital inputs required for industrial development. The rise in farm incomes also increased demand for industrial and other products, and provided momentum for growth. The development of TVEs, in turn, provided a conduit to siphon surplus labor out of the agricultural sector, enabling further productivity growth in the agricultural sector. All these were made possible by the increased freedom given to nonstate-owned firms. An upward spiral thus resulted from the initial agriculture reforms. Rapid poverty reduction in the PRC is largely attributable to these two aspects whose benefits were not experienced in India.

Despite India's emphasis on poverty reduction, major agricultural reforms have not yet been carried through from the 1980s onward in terms of institutions, incentives, and infrastructure. In addition, although India has done much to dismantle the license raj, firms still face significant constraints. For example, about 800 products remain reserved for small-scale producers. Firms with 100 or more workers cannot lay off their workers. These policies lead to uncompetitive production, and greatly hinder the entry of new firms and the growth of existing firms. Over 90% of land titles are unclear, constraining

investment in industry and the real estate sector. The cost of doing business in India remains very high (Lewis 2004).

As a result, industrial growth in India has been a more moderate 6.2% since the 1980s. Value added from the industrial sector accounts for less than 30% of GDP. Relatively slow industrial growth is one reason behind differences in economic performance between the PRC and India.

Third, PRC's opening up to the world economy has been more comprehensive. The PRC's opening up started with the establishment of special economic zones (SEZs), which allowed foreign investors 100% ownership, offered low tax rates, allowed freedom to hire and fire workers, and provided good infrastructure. Two factors in particular have made SEZs in the PRC a success. The first is that SEZ enjoyed a good investment climate. More importantly, SEZs did not remain as enclaves. They merely served as first steps for the more comprehensive opening up that closely followed. Only four SEZs were set up initially. Soon similar policies were extended to 14 coastal cities, and later extended to inland areas. The PRC's opening up was also reflected in the average tariff rate declining from around 50% in the early 1980s to just over 10% in 2004. Its share of global trade increased from 0.9% in 1980 to 5.7% in 2003.

India has also experimented with export processing zones (EPZs). However, investors did not enjoy the many benefits offered by the PRC SEZs, and India's EPZs remained enclaves. India's liberalization has also been more guarded. The average tariff rate is still about 30%. Its share of global trade increased from 0.4% in 1980 and 0.8% in 2003.

The reduction of trade and investment barriers has contributed to the PRC being more successful in attracting foreign direct investment (FDI). It received \$53.5 billion in FDI in 2003, compared to about \$4.3 billion in India. Some argue that these statistics reflect different definitions in the two countries and round tripping of FDI through Hong Kong, China into the PRC. However, even adjusting for these differences, India still lags far behind the PRC.

While the PRC has carried out more comprehensive agricultural, trade, and industrial reforms, India has gone further in reforming its service sectors. India's financial reforms since 1992 have significantly improved public sector bank performance. Gross NPLs are about 2.8% of GDP in the major state-owned banks in India compared to about 25.0% in the PRC. The Indian IT sector is booming. "Benign neglect" by the government allowed the software industry to take advantage of its large supply of skilled labor to seize the opportunity to tap into

booming world demand in the 1990s (Singh 2002). India is ahead of the PRC in telecommunications in creating an environment that encourages greater participation from private entrepreneurs. This acted as a catalyst to growth in external demand for IT services.

The experience of the PRC and India highlights the primacy of reforms in influencing economic performance. The more comprehensive and faster pace of institutional and policy reforms in the agricultural and industrial sectors in the PRC have enabled it to perform better than India both in attaining higher growth rates as well as in reducing poverty. A key feature of these reforms in the PRC was that they were grounded in the PRC's initial conditions and evolved through a process of experimentation.

Further Reforms Needed

Despite impressive growth in both countries, the PRC and India are still poor nations. Together they account for about 40% of the world's population, but only 5.5% of world GDP in 2003. Of the region's 688 million people living on less than \$1 a day in 2002, around 357 million were in India, and 203 million in the PRC. The immense scale of poverty means that simple redistribution will not significantly alleviate poverty. Inclusive economic growth through good policies is essential for sustained socioeconomic development.

Reforms have remained unfinished in both countries. In India, the fiscal deficit remains a major cause for concern. The combined fiscal deficit of the central and state governments has been hovering near 10% of GDP since the early 1990s. The persistently high fiscal deficit has imperiled national savings, crowded out private investment, put macroeconomic stability at risk, and circumscribed government's ability to deliver much needed public spending.

India's stubborn budget deficit is a symptom of many underlying problems. For example, a substantial amount of money is spent on fertilizer subsidies. However, much of this subsidy goes into supporting the inefficient domestic industry rather than poor farmers. Better measures for rural development should go hand in hand with fiscal consolidation. Most electricity continues to be a public sector monopoly, run by state electricity boards (SEBs). Almost all SEBs are making losses, which constitute a major part of state government deficits. Reforming the power sector is essential for tackling both the deficit and constraints on growth.

India's industry must be further unshackled. While India has done well in some service sectors, service sector niches are insufficient

to lift overall growth. For example, the annual revenue of the IT sector contributes to only 1.5% of India's GDP (Singh 2002). Possible areas for industrial reforms include ending the reservations of the 800 or so products to small-scale firms, making labor laws more flexible, speeding up privatization of public sector enterprises, and further reducing trade barriers (Panagariya 2001).

In the PRC, financial reform has now become central to the reform process. The PRC has carried out banking reforms since 1994. However, the reforms were limited in their pace and coverage. Following WTO accession, the banking market will be gradually opened up to foreign participation. This clearly poses challenges for inefficient state banks. To restructure domestic banks, the existing stock of bank NPLs needs to be fully dealt with. More importantly, the fundamental factor that led to the formation of NPLs in the first place needs to be corrected.

Financial reforms in the PRC are intertwined with enterprise reforms. Banking reforms have long been held back by the need to support the survival of SOEs. The gradual decline of SOEs has paved the way for the PRC to implement much-needed financial reforms. The appropriate allocation and pricing of capital that will result will play a pivotal role in determining the PRC's long-term growth potential.

Economic Prospects in the PRC and India

Both the PRC and India are poised to achieve robust growth, providing that good policies are implemented. In the PRC, high domestic savings and large FDI inflow will contribute to capital accumulation. The ratio of working age population to total population will remain relatively high over the next decade. Labor quality will continue to improve with a decent education system in place. It is likely that the PRC can sustain its 7-8% annual growth rate in the next decade. Several studies estimate that India can achieve annual growth of 7% over the next decade or two. Assuming that the PRC grows at 8% and India at 7% per annum, PRC's GDP at 1995 US dollars would increase from \$1.32 trillion in 2003 to \$4.88 trillion in 2020, while GDP per capita would rise from \$1024 to \$3230. India's GDP would grow from \$0.56 trillion in 2003 to \$1.76 trillion in 2020 with per capita GDP increasing from \$525 to \$1271.

Conclusions

This brief demonstrates that strong economic growth in both the PRC and India is associated with economic reforms. It shows that the role of governments and competitive markets must be divided properly so that they can complement each other. Firms and farms must be unshackled to improve productivity and become the drivers of growth. Governments must play an enabling role by maintaining macroeconomic stability, improving the business and investment climate, and addressing market failures.

An important lesson of the PRC's success is the adoption of the East Asian model of development with the emphasis on labor-intensive production. In this regard, it is important that in India, labor is siphoned out of the agricultural sector, and that labor-intensive industries grow to absorb surplus labor. However, the route that it took on both agriculture and the TVEs was unique to the PRC's initial conditions and may not be readily replicable elsewhere. The policy and institutional reforms will need to be tailor-made for India.

Sustained, inclusive growth is contingent on continued reforms in both countries. The consequent emergence of the PRC and India will bring profound changes to their own people, Asia, and the world economy.

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