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RESEARCH ON INDIA AND CHINA: INTERCONNECTIONS AND COMPARISONS

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INTRODUCTION

As India and China reform and develop, the global economy is affected by what happens in these two major markets. Most multinationals have Indian and China strategies, and increasingly the growing interconnections between these two economies are shaping the opportunities for business. The sheer size of the economies is certainly a factor. India's population has surpassed 1 billion people and its economy is the fourth largest in the world; China has approximately 1.3 billion people and is now estimated to be the second largest economy by purchasing power parity measures. But more than size, the dynamics of change in these two countries present new but unfamiliar markets, as well as the possibility of rapid growth for some time to come. Moreover, reforms in both economies have made them increasingly market-oriented and open to foreign trade and investment. Indian and Chinese companies are becoming major global players as they expand at home and invest abroad.

Still, the challenges of rapid change with many conflicting interests at stake are daunting for both governments. Further, differing political systems raise intriguing questions about possible constraints on progress. Scenarios abound about the ways reforms in both countries could get derailed. Financial crises sometimes seem only a step away.

For the most part, analysts have evaluated China's reform and development progress as being ahead of India's. By many indicators—whether growth rates, literacy, trade, or infrastructure—China's numbers are more impressive than India's. Judging by foreign investment alone, China must look like a better bet for companies. In 2005, for example, China received $60 billion worth of foreign investment while India only received $6 billion.[1] Although differences in how FDI is counted overestimate the figures for China and underestimate them for India, these figures represent a huge advantage for China. China's successes have not gone unnoticed in India. Leaders and policy makers have pushed ahead with reforms since 1991, resulting in an economy that is much more market-oriented than any time since Independence when a Soviet-style, partially planned system was put into place. As a result, India's growth rate has picked up, substantially narrowing the gap with China's.

This special issue on India and China presents eleven research contributions that focus on a particular aspect of development in either India or China, or explicitly incorporate a comparative perspective. Taken together, these new studies paint a shifting view of the China-India comparison. Just a few years ago one would be hard pressed to find articles arguing the promising future of India over China. Even today this is not a common perspective. These studies go beyond statistics, however, to understand the institutions and government-business interactions behind the dynamics of change. As a result, they reveal many problems in both economies, but also come to more nuanced conclusions about how to gauge progress. While some authors do not address which economy is ahead, overall progress in India is clearly presented, and in some aspects, such as profitability of companies and the strength of the financial sector, the authors explicitly say that India is doing better than China. Interestingly, none of the articles conclude that China has an unassailable lead.

CONTRIBUTIONS TO THE DEBATES

The topics addressed are organized into five areas: Financial and Fiscal Challenges, the Emerging Private Sector, Comparative Business Environments, Legal Contexts and Intellectual Property Rights, and Strategic Aspects of Indian-Chinese Economic Relations. The sections that follow will summarize briefly the main thesis of each contribution and point out common themes or areas of agreement or contrasts.

Financial and Fiscal Challenges

Subramanian Swamy, in his article "Financial System Constraints in China and India: A Comparative Perspective," argues that both countries face high probabilities of financial crises by 2010, which will jeopardize their chances of sustained growth. In spite of quite good macroeconomic indicators and impressive growth, sustained growth is not likely if financial institutions do not function well. Unlike the Asian crisis in 1997, which was precipitated by foreign currency shortages, in China the main trigger will be the burden of non-performing loans in the banking sector. In India, it will be fiscal deficits at both the central and local levels resulting in spiraling debt and inflation. Avoiding these crisis scenarios is possible, Swamy argues, but will be politically challenging.

Neither country has a good record with either the banking system or their fiscal structures. In banking, however, many analysts, including Swamy, argue that India is better off than China. Bad debt as a percent of GDP is around 11 percent in India but at least 20 percent in China.

China's banking problems are tied to the political need to support poorly performing state-owned enterprises instead of the more efficient, profitable and dynamic private sector. In addition, there is a lack of ability and information within banking that prevents sound analysis of credit reports and proper due diligence. Banking assets in China are also increasingly tied to real estate, which itself is experiencing a bubble and therefore subject to sudden collapse. In any scenario, to the extent that these problems create inflation, a resulting credit squeeze will slow the economy considerably and put many small, potentially profitable companies out of business.

For India, the scenario is a bit different. Swamy argues that since India's national budget deficit uses about 90 percent of household savings, this puts a serious constraint on the funds available for private investment. Changing this situation is difficult with

95 percent of revenues committed to entitlements. In addition, the states in India are also in fiscal trouble. This situation combined with low savings and low foreign investment means that interest rates will rise and therefore growth will slow.

While neither scenario is desirable, Swamy sees more hope for India than China. He argues that at least India has a democratic political system that allows change if pushed hard enough, but in the case of China, a major political upheaval would have to occur before the necessary changes could be made to avoid, or deal with, a financial crisis.

Looking closely at the fiscal systems in both countries in the article "Fiscal Decentralization and Economic Growth: A Comparative Study of China and India," Mark Rider and Jorge Martinez-Vazquez see many problems but do not have such dire predictions. In fact, they conclude that crises are not likely, at least in the near future. But their purpose is different although related: using the two case studies of India and China, they analyze the possible connections between fiscal decentralization and economic growth by looking at the imbedded incentives within the institutional arrangements that may contribute to, or inhibit, growth.

Rider and Martinez-Vazquez describe in detail the reforms of China's and India's fiscal systems, and conclude that neither has decentralized sufficiently to give appropriate authority or resources to the local levels. This, in turn, results in poor expenditure choices, poor service affecting human capital development, plus lack of adequate capital investment in infrastructure. All of these problems potentially adversely affect long term growth. China and India have major differences in why they experience lack of fiscal discipline and little accountability, but in the end, the authors argue, they exhibit similar situations of poor performance of their fiscal systems.

In a third paper addressing these issues, Kellee Tsai's article "Debating Decentralized Development: A Reconsideration of the Wenzhou and Kerala Models," takes a critical look at two supposedly successful models of local economic dynamism. In the case of Wenzhou, China, private capitalism thrived in the 1980s well before China officially sanctioned these types of companies. In the case of Kerala, India, an elected communist government since the 1960s has provided public services such as health care and education that resulted in human development indicators that surpassed national averages even though the economy was very poor. Progress in these localities brought them national, and even international, attention, leading to calls to understand the reasons for their successes in order to replicate them. Tsai's analysis of these two cases points out their specific contexts and limitations, leading her to question the wisdom of replicating them as well as the sustainability of these two development "models" even in their home regions.

Fiscal and financial factors play a key role in understanding these two development processes in Tsai's analysis. In Wenzhou, as a result of reforms that led to fiscal decentralization, local government officials had incentives to encourage private business initiatives because they could keep much of the tax revenue generated by profitable companies. At the same time, while the private sector thrived, it did so by obtaining financing almost totally outside of the state banking system. In recent years, new stages of reforms have meant that city and county governments, rather than township governments, have been able to capture relatively more tax revenue and have shifted their support towards larger enterprises. These trends have meant that both small enterprises and local government at the township levels have faced serious financing constraints, leading to less growth in output and employment, and to falling support of key public servants such as teachers and doctors.

In Kerala, since the provision of social services requires high levels of government expenditure, there is concern over the financial viability of continuing such services in the future. In fact, Kerala has the largest fiscal deficit of all the India states. One underlying problem is that the local economy has not created the basis for indigenous growth, and therefore government revenue. Tsai suggests that despite the appeal of this development model from a social point of view, it has not been able to overcome the trade-off between distribution and growth.

Tsai suggests that the decentralized nature of the development processes in Wenzhou and Kerala have played themselves out. In Kerala, policies to promote sustainable growth will be needed to fund desired social programs. In Wenzhou, as in other areas of China, a more efficient financial system and better allocation of fiscal revenues and expenditure responsibilities are needed. These ideas are consistent with the arguments made in the Swamy paper for the financial sector and by Martinez-Vazquez and Rider for the fiscal sector as well.

The Emerging Private Sector

Looking at the small-scale sector in China, “China’s Small Enterprises in Economic Transition: Successes and Problems” by Fuxin Jiang and Chunping Zhou, outlines the dynamic but sometimes difficult development of indigenous, private and collective companies throughout the reform period. They emphasize that these companies have played a major role in transforming the economy into a more market-oriented one, but at the same time, their market niches have been in flux necessitating firm level changes in management and organization in order to stay viable.

Impressive growth of the small-scale sector in China has helped to increase the proportion of industry and services relative to agriculture in GDP, increase urbanization, move many households out of self-sufficient agricultural production to labor specialization within the market, and contribute to international exports. The growth of small-scale enterprises has occurred despite pro large, state-company biases throughout the system. The authors document numerous studies of small firms that point out problems with property rights, access to capital, over regulation leading to high operating costs, lack of specialization and integration into the supply chain, in addition to facing global competition themselves in many cases.

Nonetheless, Jiang and Zhou conclude that this sector has ample room to grow and note that the central government has recently passed new laws to help mitigate some of the more serious, structural challenges to the private sector. Comparing China’s state share in GDP of 32 percent to about 5 percent on average in developed countries and about 10 percent on average in developing countries, the authors see major opportunities for further growth in the private sector. China’s growing incomes fueling consumer demand bodes well for further growth and development of these dynamic companies.

Yasheng Huang's contribution, "Assessing Financing Constraints for Domestic Private Firms in China and India," uses survey data to investigate how the financial systems serve the capitalist classes in each country. Huang finds that in the case of bank lending to small, private companies, India's system outperforms China's. While Jiang and Zhou do not consider the situation in India, Huang's results are consistent with the problems the authors identify for small companies in China.

Huang presents the puzzle that while China's banking system lends approximately twice as much as India's, 80 percent of Chinese firms in the survey reported moderate to major obstacles in borrowing funds as compared with 52 percent of the Indian firms. Further, the perceived reason for the funding constraint in China was a lack of funds. Using various regressions to control for firm characteristics, Huang finds that small firms are the most affected by these constraints in China, whereas firm size is not significant in the case of India. The overall conclusion of this study is that China's financial sector has a constraining policy bias against small, private firms, which is one of the legacies of the former planned economy. As a result, Huang questions studies that have put China ahead of India in terms of progress toward reforms and in terms of how market-oriented the two countries are. He concludes that India is working to improve an underdeveloped banking system with technical problems of performing proper risk assessments, but that China has a biased banking sector due to policy preferences. One implication of these results is that India is likely to make more progress in its financial and banking reforms than China. This result comes from a different perspective than Swamy's evaluation of the two banking systems, but it is fully consistent with his conclusions as well.

Comparative Business Environments

Taking a comparative macro view, Haley and Haley in their article "The Indian Elephant and the Chinese Dragon: Differing Development Strategies of India and China and Effects on Business Environments," discuss four key characteristics of the two economies: the role of the state, trade and foreign investment paths, government institutions, and emphases on infrastructure. Understanding the differences in these four areas help the authors identify strengths and weaknesses in the business environments for indigenous companies.

Haley and Haley argue that while both economies have weak financial intermediation that hurts companies, China's successful companies typically rely on large amounts of state provided capital. Indian companies do not have this luxury, and as a result, successful companies in India tend to be in industries where capital constraints are less important such as in information technology. A further implication of the two approaches is that Indian companies function under more market pressure than Chinese, while Chinese companies are challenged to cooperate with government initiatives. In terms of returns on investment and returns on equity, Chinese companies do better than Indian companies in consumer durables, telecommunications, textiles and garments, while Indian companies do better in software, pharmaceuticals, biotech, capital goods and materials.

The authors overall assessment is that Indian companies on average outperform Chinese companies. India has produced a substantial number of world class companies such as Infosys and Wipro while China has not. They argue that India certainly has work to do to improve its business environment, such as improving infrastructure and energy. However, China's challenges are more onerous in that a retreat of government dominance of business is required for progress, and this will take major political and institutional change.

The article "High Technology Clusters in India and China: Divergent Paths," by Susan Walcott and James Heitzman looks at the specific business environment of high tech parks in each country by focusing on four case studies: Bangalore and Hyderabad in India, and Chongqing and Chengdu in China. Both countries have tried to encourage clusters of high tech companies to help promote knowledge-based industries and development generally. Like the Haley & Haley research, this study finds substantial differences in outcomes as a result of differences in the relationship between business and government. In India the nature of political intervention in the creation of industrial clusters, they find, has typically exhibited a bottom-up approach led by entrepreneurs and highly skilled labor. In China a top-down approach consistent with its centralized past has been more apparent.

For example, one reason Bangalore and Hyderabad attracted high tech industry was because they both had very prestigious universities that could supply a skilled labor force. Chongqing and Chengdu, on the other hand, benefited from being a center piece in the national government's "go west" movement that brought substantial financing with it. The authors acknowledge that in India the government plays a role, as do individual companies and entrepreneurs in China. However, one of the dominant reasons for the rise of high tech parks in central China is very large government investment in infrastructure. Indeed, private and foreign capital remains relative scarce in that part of China. In India, by contrast, independent, private firms in the information technology industry formed clusters of activities, and only later began to lobby for better infrastructure. The end result is that on the surface these city centers look somewhat similar, but the forces creating and shaping them are quite different in the two countries.

Legal Contexts and Intellectual Property Rights

A comprehensive overview of the development of China's and India's legal systems is given in the article "The Indian and Chinese Legal Systems: A Comparative Perspective," by Michael Burke, Kenneth Cutshaw and Rahul Krishna. Covering six broad aspects, the authors trace the evolution of the two legal systems as the economies developed and more recently, influenced by changes in the global economy and institutions.

India's legal foundations began with the philosophy of *dharma* and the classical texts of the Vedas and Sruti according to Burke, et al. Later the East Indian Company and British influence generally formalized a system of laws and judicial procedures. With independence, India built a democratic political system with its new constitution, but built its legal system on the core of the former colonial legal structure.

China's philosophical foundations were rooted in Confucianism, Daoism and Legalism. The authors suggest that these traditions led to a certain skepticism about the law with more reliance on bureaucratic order. After the establishment of the People's Republic in 1949, the Communist government led the country as the only significant political party strengthened by a supporting bureaucracy without the need for a separate legal system per se, and later virtually destroyed the legal profession during the Cultural Revolution. As part of the economic reform process, China has slowly rebuilt its legal system, including revising its constitution to cover the rights of individuals and property, and to bring its laws into conformity with international norms, especially in the realm of business.

Burke et al. describe many ways in which both India and China have made major strides in modernizing and improving their legal systems largely in response to their desires to join the international community and participate in global markets. Overall, however, the authors conclude that India had a stronger legal foundation in philosophy and institutions, and therefore has some advantage in this regard.

Looking at the particular case of intellectual property rights (IPR) in China, Keith Maskus underscores the tremendous progress China has made in his article "Assessing Coherence of the Intellectual Property Rights Regime in China." With respect to registering and protecting intellectual property, China's laws now meet international standards and in some cases are on par or even surpass advanced countries. One of the impetuses for pushing these changes was to meet the requirements for joining WTO, including the Trade Related Aspects of Intellectual Property Rights, or TRIPS.

Laws on paper, however, do not necessarily mean that IPR protection is meaningful, finds Maskus. The author makes a strong case that poor administration of the rules and lack of enforcement render China's impressive laws ineffective. In a few developed parts of the country, such as Shanghai and Beijing, domestic companies increasingly understand that they also need IPR protection in order to thrive. However, the vast majority of companies, local governments and consumers benefit from infringement, making it exceedingly difficult to turn the tides towards successful enforcement. Maskus concludes that for the time being the situation is likely to get worse, especially as the less developed regions of China struggle to improve their economies.

In sharp contrast to the thesis developed in the Maskus article on China, the article by Nauriyal, "TRIPS-Compliant New Patents Act and the Indian Pharmaceutical Sector: Directions in Strategy and R&D," is a case study in how recent changes to IPR law is likely to affect the pharmaceutical sector in India. Nauriyal's study implies that the Patent Act, amended in 2005, matters to industry, functions reasonably well, and is enforceable at least to some degree. Nauriyal begins by describing how the Indian pharmaceutical industry developed in response to the original Patent Act passed in 1970. While the system was no doubt far from perfect, its existence and influence beginning in the 1970s is consistent with the Burke et. al observation that India historically has had a broad legal foundation for some time.

Because India chose an import substitution approach with little interest in attracting foreign investment until the 1990s, the patent laws were only relevant to domestic companies. In addition, India exports drugs primarily to developing economies. The vast majority of products in the Indian pharmaceutical industry were reversed engineered or fall in the generic realm. Nauriyal reports that at this point 97 percent of the drugs sold in India are off-patent. With reforms aimed in part at liberalizing foreign investment and trade, protection of IPR has taken on new dimensions. With the revisions of the patent act, more foreign investment in pharmaceuticals is expected; however, Nauriyal notes that depending on how successful enforcement is perceived to be in India, foreign firms may choose to work with affiliates rather than outsource.

Strategic Aspects of Indian-Chinese Economic Relations

The concluding article in this special issue is entitled "The Strategic Context of India's Economic Engagement with China," by Anupam Srivastava. This study looks at the growing interactions between China and India and considers the interplay between economic cooperation and the geo-strategic considerations of the relationship. Srivastava's purpose is to explain what has changed in Indian-Chinese relations to allow renewed efforts at economic and diplomatic warming? Srivastava argues that both countries have economic reasons to engage. China is looking to take advantage of India's large market and the economic opportunities available with India's neighbors. India wants to do the same with China's market and the Asia-Pacific countries generally. Strategically, China hopes to counter any U.S.-Indian moves, and India needs to work with China to secure energy sources without bidding up prices unnecessarily.

These changes have led to increased trade and investment between the two rapidly growing economies. In 1991 bilateral trade was only $332 million, but by 2005 it had grown to nearly $14 billion. Based on these statistics, China is India's third largest trading partner and India is ranked twelfth for China. Building on this momentum, China's Prime Minister, Wen Jiabao, visited India in April, 2005, and India's oil minister, Mani Shankar Aiyar, visited China in January, 2006. The top leaders, President Hu and Prime Minister Singh, are set to exchange visits in 2006.

Meanwhile, the U.S. has courted India and signed a 10-year defense agreement June, 2005. These overtures are in part aimed at building hedging partnerships outside of China's sphere of influence. Further, while relations have warmed, India and China have unresolved border issues and suspicion remains on both sides. China also is clearly working to build relations with India's neighbors, causing some concern in Delhi. Hence, the future of this bilateral relationship is uncertain. Srivastava concludes that while the growing economic ties are significant, they may not be sufficient to overcome competition in the security arena.

CONCLUSION

By most accounts, in economic and regional political terms China is ahead of India. In some cases, China is far ahead. The statistics still tell a story of China beating India on indicators ranging from savings and investment, foreign trade and capital inflows, and output growth and per capita incomes. Many of the studies presented here, however, point to a growing respect for the relative importance of the "software" elements of successful development such as a market context that allows private companies to compete and thrive, limits on poorly performing financial institutions, a basic legal foundation, and institutions that allow for political compromise. With these firmly in place, India should be able to fix its "hardware" deficiencies in infrastructure, and foreign companies should increasingly be attracted to the Indian market bolstering the country's saving and investment. Changes in China to match India's institutional strength are expected to be much harder.

Still the puzzle of which country is doing better remains. China has many serious problems, as pointed out by these contributions, including an uneven playing field for the private sector, a very weak financial sector, poor enforcement of IPR, trade patterns that play to foreign markets but may not help domestic ones, and growth but with poor efficiency. At the same time, China by many economic measures has done better than India by far. Is China's lead a result of timing—that is, that China began reforms more than a decade before India but that with time India will catch up? Or are China's successes the foundation for economic and political leadership in Asia far into the 21st century? While this set of articles collectively lean towards India catching up, more research is needed to understand the underlying forces of development in each economy. The hope, of course, is that both countries will prosper, and will work to cooperate peacefully on security issues.

NOTES

1. Marcus Walker, "India Touts Its Democracy Bid to Lure Investors Away from China," *The Wall Street Journal*, 30 January 2006, p. A2.