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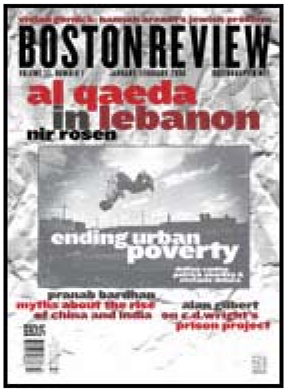

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What Makes a Miracle

Some myths about the rise of China and India
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After more than a century of relative stagnation, the economies of India and China have been growing at remarkably high rates over the past 25 years. In 1820 the two countries contributed nearly half of the world's income; by 1950, with the industrialized West having pulled away, their share had fallen to less than one-tenth. Today it is just less than one-fifth, and projections suggest that by 2025 it will rise to one-third. (In 2008 the World Bank is expected to issue revised numbers about cost of living in China and India, which may somewhat reduce these estimated income shares, both current and future).

The consequences of this expansion are extraordinary. The Chinese economy in particular has made the most headway against poverty in world history, with hundreds of millions of people moved out of the most extreme poverty within just a generation. (The environmental consequences are comparably remarkable, though perhaps proportionately disastrous).

What explains this strikingly rapid growth? The answer that continues to dominate public discussion in the United States runs along the following lines: decades of socialist controls and regulations stifled enterprise in India and China and led them to a dead end. A mix of market reforms and global integration finally unleashed their entrepreneurial energies. As these giants shook off their "socialist slumber," they entered the "flattened" playing field of global capitalism. The result has been high economic growth in both countries and correspondingly large declines in poverty.

While India's performance has been substantial, China's has been truly dramatic. The particularly dramatic Chinese performance (like the earlier economic "miracles" in South

Korea, Taiwan, and Singapore) suggests, in the dominant narrative, that authoritarianism may be better than democracy for development—at least in its early stages. Regional economic decentralization provided local autonomy and incentives, and, even without democracy, led to broad-based local development. But the narrative warns that global capitalism has brought rising inequality, more in China than in India. The idea is that this may portend serious trouble for Chinese political stability, as China does not have the capability of democratic India to let off the steam of inequality-induced discontent.

This story contains a few elements of truth and provides many comforts to our preconceptions. But through sheer repetition it has acquired an authority that does not withstand scrutiny.

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Start with the claim that global integration and associated market reforms resulted in high growth, which in turn produced dramatic declines in extreme poverty. Applied to China, the timing simply does not fit. China has indeed made large strides in foreign trade and investment since the 1990s, but well before then, say between 1978 and 1993, the country had already achieved an average annual growth rate of about nine percent—even higher than the impressive seven percent growth rate in East Asia between 1960 and 1980.

China's poverty-reduction storyline is similarly flawed. While expansion of exports of labor-intensive manufactures lifted many people out of poverty over the past decade, the principal reason for the dramatic decline over the past three decades may lie elsewhere. World Bank estimates suggest that two-thirds of the decline in extremely poor people (those living below the admittedly crude poverty line of one dollar a day per capita at 1993 international parity prices) between 1981 and 2004 had taken place by the mid-1980s. Much of the extreme poverty was concentrated in rural areas, and its large decline in the first half of the 1980s may have been principally the result of domestic factors that have little if anything to do with global integration: a spurt in agricultural growth following de-collectivization, in which output increased at 7.1% per year on average between 1979 and 1984, almost triple the 1970-78 rate; a land reform program, involving a highly egalitarian distribution of land-cultivation rights subject only to differences in regional average and family size, which provided a floor for rural income; and increased farm procurement prices.

As for India, market reforms may not be mainly responsible for its recent high growth. Reform has clearly made the Indian corporate sector more vibrant and competitive, but most of the Indian economy lies outside the corporate sector; for example, 93 percent of the labor force works outside the corporate sector, private or public.

Take the fast-growing service sector, where India's IT-enabled services have acquired a global reputation while employing less than a quarter of one percent of the total Indian labor force. Service subsectors 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 total service-sector output. Two-thirds of service output is in traditional or "unorganized" activities, in tiny enterprises often below the policy radar and unlikely to have been directly much affected by regulatory or foreign trade policy reforms. It is a matter of some dispute how much of the growth in traditional services (mostly non-traded) can be explained by a rise in service demand in the rest of the economy, and how much of it is a statistical artifact, since the way output is measured in these traditional services has been rather shaky all along.

As for poverty, the latest Indian household survey data suggest that the rate of decline, if anything, slowed somewhat in 1993-2005—the period of global integration—compared with the '70s and '80s. Moreover, some non-income indicators of poverty such as those relating to child health, already rather dismal, have hardly improved in recent years. (For example, the percentage of underweight children in India is much larger than in sub-Saharan Africa and has not changed much in the past decade or so). Growth in agriculture, where much of the poverty is concentrated, has declined somewhat over the past decade, largely because of the decline of public investment in rural infrastructure such as irrigation. Little of this has much to do with globalization. Indeed, some disaggregated studies across districts in India have found trade liberalization slowing down the decline in rural poverty. Such results may indicate the difficulty displaced farmers and workers have had adjusting to new activities and sectors due to various constraints such as minimal access to credit, information, or infrastructural facilities like power and roads; the high-school-dropout rate; and labor market rigidities—even as new opportunities are opened up by globalization.

The pace of poverty reduction in India has been slower than that in China not simply because Chinese growth has been faster, but also because the same one percent growth rate reduces poverty in India by much less, thanks largely to higher wealth inequalities (particularly in land and education). The Gini coefficient (a standard statistical measure of inequality, with a value of one indicating extreme inequality and zero indicating perfect equality) of land distribution in rural India was 0.74 in 2003; the corresponding figure in China was 0.49 in 2002. To a large extent this difference reflects a higher proportion of landless and near-landless people in India. In addition, educational inequality in India is among the worst in the world. According to the *World Development Report 2006*, the Gini coefficient of the distribution of adult schooling years in the population was 0.56 in India in 1998/2000, which is not only higher than China's 0.37 in 2000, but even higher than almost all Latin American countries. To a large extent, this indicator reflects the high number of illiterate and near-illiterate people relative to the rest of the population in India.

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The storyline about China and India's "socialist slumber" is equally suspect. China and India have become poster children for market reform and globalization in much of the financial press, even though both countries' economic policies with regard to privatization, property rights, and deregulation have departed demonstrably from free-market orthodoxy in many ways.

And what about the earlier period? Was it really an utter waste? While socialist control and regulations undoubtedly inhibited initiative and enterprise in both countries, the positive legacy of reforms undertaken in the ‘70s and ‘80s cannot be denied, particularly in China’s recent pattern of state-controlled capitalist growth.

China’s earlier socialist period arguably provided a good launching pad for market reform. That foundation provided wide access to education and health care; highly egalitarian land redistribution that created a rural safety net and thus eased the process of market reform, with all its wrenching disruptions and dislocations; increased female labor participation and education that enhanced women’s contribution to economic growth; and a system of regional economic decentralization (that linked the career paths of Communist Party officials to local area performance). County governments were in charge of production enterprises long before Deng Xiaoping’s economic reforms set in, and, even more significantly, the earlier commune system’s production brigades evolved into the highly successful township and village enterprises that led the later phenomenal rise of rural industrialization.

In all these respects China’s legacy from 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 half-flippantly, that the Chinese are better capitalists now because they were better socialists then!

The earlier period’s legacy in both countries is also evident in the cumulative effect of the state’s active role in technological development. It is often overlooked that the Chinese have succeeded in international markets with more than simple labor-intensive products such as clothing, toys, shoes, and wigs. Both China and India (but China more so) have succeeded in exporting more sophisticated products than is usual in countries in their respective per capita income ranges: China, in consumer electronics, including computers and other information- and communication-technology-related goods, and auto parts; India, in software, pharmaceuticals, vehicles, steel, and auto parts. This performance is remarkable (though more in gross value of exports than in value-added terms, as some of the components and technology used in production are acquired from abroad) and is due primarily to sizeable skill and technological bases, enriched over the years of “socialist slumbering” by indigenous learning-by-doing and nurtured by government policies of building domestic capability—sometimes at the expense of static resource allocation efficiency.

Of course, there are many cases in which protection from foreign competition sheltered massive inefficiency. But the overall storyline is by no means so simple. Consider auto parts. For many decades both countries practiced protection of “local content” (of components) in automobiles, contrary to the orthodox free-trade policy prescription. As a result workers in the auto parts industry acquired skills necessary to compete successfully in the global economy and have now reached international best practice.

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What about democracy's role in economic growth? The much more dramatic success of China (and, earlier, that of other East Asian countries under authoritarian regimes) compared with India does not in any way prove the superiority of authoritarianism over democracy in matters of development. Authoritarianism is neither necessary nor sufficient for development. That it is not necessary is illustrated not only by today's developed countries, but by scattered cases of recent development success: Costa Rica, Botswana, and now India. That it is not sufficient is amply evident from disastrous authoritarian regimes in Africa and elsewhere.

The relationship between democracy and development is much more complex than the conventional wisdom suggests. Even if we were not to value democracy for its own sake (or regard it as an integral part of development by definition), and looked at it in a purely instrumental way, democracy has at least four advantages from the point of view of development. Democracies are better able to avoid catastrophic mistakes, (such as China's Great Leap Forward and the ensuing great famine that killed nearly thirty million people, or its Cultural Revolution, which may have resulted in the largest destruction of human capital in history) and have greater healing powers after difficult times. Democracies also experience more intense pressure to share the benefits of development, thus making it sustainable, and provide more scope for popular movements against industrial fallout such as environmental degradation. In addition, they are better able to mitigate social inequalities (especially acute in India) that act as barriers to social and economic mobility and to the full development of individual potential. Finally, democratic open societies provide a better environment for nurturing the development of information and related technologies, a matter of some importance in the current knowledge-driven global economy. Intensive cyber-censorship in China may seriously limit future innovations in this area.

All that said, India's experience suggests that democracy can also hinder development in a number of ways. Competitive populism—short-run pandering and handouts to win elections—may hurt long-run investment, particularly in infrastructure, which is the key bottleneck for Indian development. Such political arrangements make it difficult, for example, to charge user fees for roads, electricity, and irrigation, discouraging investment in these areas, unlike in China where infrastructure companies charge full commercial rates. Competitive populism also makes it harder to cut losses resulting from experimentation in industrial policy in India, where retreating from a failed project—with inevitable job losses and bail-out pressures—has electoral consequences that discourage leaders from carrying out policy experimentation in the first place. Finally, democracy's slow decision-making processes can be costly in a world of fast-changing markets and technology.

China is widely, and rightly, acclaimed for its decentralized development: in the 1980s and '90s local industries flourished under the control of local governments and collectives. This aspect of industrialization has largely bypassed India so far, even though important constitutional changes favoring devolution of power to local governments were carried out in the '90s. Of course, decentralization is not always a good thing for development. Some have complained that decentralization in post-Soviet Russia was growth-retarding, as provincial governments were captured by oligarchs, thus legitimizing the subsequent centralization of power by Vladimir Putin. Although egalitarian land reform in China may have helped avert the capture of local institutions by local elites—at least in the initial years of market growth—the problem has plagued regional decentralization in India and Russia.

But even China has had trouble with decentralization in recent years. With local party officials prospering in a reward system that emphasizes 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 them in, particularly in matters of land acquisition (where local officials are often in cahoots with local commercial developers), toxic pollution and violation of consumer- product safety regulations (often in collusion with local businesses). The "harmonious society" mantra chanted by the central leadership has not yet succeeded in curbing the capitalist excesses of local business and officialdom. The centralization of tax reform since 1994 has reduced the incentives of the local bureaucracy to serve social needs, particularly in interior provinces. The lack of democratic-accountability mechanisms is, and will continue to be, felt acutely by local populations who face limits both in the types of economic growth they can pursue and in the delivery of social services.

In short, in the absence of democratic devolution, China's much-celebrated regional decentralization may now be a source of much discontent and may undermine the economic growth it has done so much to foster.

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A final element of conventional wisdom is that globalization has led to rising inequality, and that inequality-induced grievances, particularly in rural China, cloud the country's political future and hence its economic stability. But the effect of globalization on inequality is difficult to disentangle from that of other ongoing changes (such as skill-biased technical progress due to new information and communication technology), and so the causal link between globalization and inequality is not always clear. Moreover, Chinese provinces with more global exposure and higher growth did not have a greater rise in inequality compared with the other provinces in the interior. Decline in agricultural growth in recent years, in both China and India, may also have something to do with the rise in aggregate inequality, as inequality is significantly lower in agriculture than in other sectors.

As for inequality-induced political instability, a frequently cited fact reported from official police records is that incidents of social unrest have multiplied nearly nine-fold between 1994 and 2005. While the Chinese leadership is right to be concerned about inequality, the conventional wisdom in this matter is somewhat askew, as has been pointed out by Harvard sociologist Martin Whyte and his team. Data from their 2004 national representative survey in China show that the presumed disadvantaged in rural or remote areas are not particularly upset by rising inequality. This may be because of the "tunnel effect," a familiar concept in the literature on inequality: when you see other people prospering you are hopeful that your chance will soon come (you are more hopeful in a tunnel when blocked traffic in the next lane starts moving). This is particularly so with the relaxation of restrictions on migration from villages and improvement in roads and transportation. Farmers are incensed by forcible land acquisitions or the severe environmental damage of land, air, and water than they are by inequality. Chinese leaders have so far succeeded in deflecting the wrath felt toward corrupt local officials and in localizing and containing rural unrest.

It may seem counterintuitive but the potential for unrest is arguably greater in the currently booming urban areas where, along with the breaking of the real estate bubble, a possible global recession could ripple through the excess-capacity industries and financially-shaky public banks. With a more Internet-connected and vocal middle class, a recent history of massive worker layoffs, and a large underclass of migrants, urban unrest could be more difficult to contain.

When faced with political shocks, the Chinese leadership has a tendency to overreact, suppress information, and act heavy-handedly, unnecessarily exacerbating the problem. Still, China now has a very strong economy, which can act as a cushion, and provide more financial resources for assuaging local grievances.

Chinese and Indian economic performance has been far better in the last quarter-century than in the previous two hundred years—and this is one of the striking events in the recent history of the international economy. Other countries must adjust to this reality, and learn to treat the partial restoration of the earlier global importance of these two countries as an opportunity for trade, investment, and exchange of ideas, not as a threat. (We also need to work in tandem with them on the environment.) But we must remember that the story of their rise is more complicated and nuanced than standard accounts make out. That more complex story includes the positive legacy of China and India’s earlier statist periods, which offers general lessons for the process of development much too often ignored.