India’s Lag Behind China And Policy Suggestions To Overcome It

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I. ABSTRACT

As Bosworth and Collins (2008) point out, India and China have both come a long way from 1980 to the present in terms of economic growth as measured by GDP per capita. Yet the path towards economic development has been different for both countries. In econometric terms, the annual GDP growth rate of China averaged around 9.3 percent between 1978 and 2004, while that of India averaged around 5.4 percent (Bosworth and Collins, 2008). This paper does an introductory comparative study of the economic structure of the two countries through a three-sector lens, and points out differences in how those sectors have developed. It then shifts its focus to why India has not had the same levels of prosperity as China in terms of exports and economic growth. Finally, it offers an overview of three policy suggestions that would aid in the narrowing of this gap in the future — greater industrialization, labor reforms, and financial reforms.

II. COMPARATIVE STUDY

Bosworth and Collins (2008) investigate the economic growth patterns of the two countries by constructing growth accounts that uncover the supply-side sources of output change for each economy. These growth accounts roughly coincide with the typical macroeconomic definition of a three-sector economy.

The agricultural sectors of both countries, they note, did benefit from the Green Revolution but the returns for the Chinese agricultural sector were greater because of the added benefits of fundamental reforms such as restoration of family farms in the late 1970s, among others. China's agricultural output experienced a yearly growth rate of 4.6 percent compared to India's much

lower 2.5 percent. Rao (2005) argues that these land reforms that preceded economic reforms helped China build new capital at a much faster rate than India. Bosworth and Collins (2008) also noted that agricultural employment in India continued to increase between 1993 and 2004, while it decreased in China. According to the 2001 census data interpreted by Panagariya (2005), 77 percent of the labor force in India lived in rural areas with 58.5 percent employed in agriculture.

The secondary or industrial sector (by industry, our main concern here is manufacturing) had grown to constitute almost 50 percent of Chinese GDP, whereas it accounted for less than 30 percent of Indian GDP (Bosworth and Collins 2008). Despite both countries experiencing commendable increases in capital growth, China experienced a much higher increase in factor productivity.

Such findings resonate with other literature, in that China has focused highly on industrialization by lowering barriers to trade both more rapidly and more aggressively than India. India has not focused on the traditional economic growth model of industrialization through low-wage export-oriented manufacturing industries, and has taken the route towards service-producing industries. While China's impressive increases in total factor productivity have been skewed towards the secondary sector, the same has been happening in India in the services sector. This has arguably been one of the biggest structural differences in their development. Despite India's service sector-oriented approach, however, Bosworth and Collins found that by 2004, Chinese output per worker had surpassed India's in all three sectors, albeit by lower margins in the services sector.

III. EXPORTS AND GROWTH LAGS

Panagariya (2007) details the stark differences between India and China's export industries. Drawing from the findings of Bosworth and Collins (2008), it is not surprising that an increased focus on the secondary sector in China led to its share of world exports rising to 5.8 percent by 2003, whereas India's share stood at less than 1 percent. Despite India's liberalization period through the 1990s where tariff and non-tariff barriers (NTBs) to trade were greatly reduced, the 10.7 percent growth rate of its exports was lower than that of China (12.9 percent during the 1980s and 15.2 percent in the 1990s). This, Panagariya argues, is because services are less tradeable than industrial output, but that claim is debatable in the present nature of the global economy, where borders matter little in non-goods trade. It is more likely that the education-to-employment pipeline is disrupted by supply-side issues — higher education infrastructure remains inadequate in India (despite the success of some institutions such as the Indian Institutes of Technology and Indian Institutes of Management) and a non-vertically strengthened education system which means that the percentage of high school graduates going to college remains low.

The greater issue with a services sector-led growth strategy (especially in India) is that many high-productivity service industries such as information technology (IT), despite being high growth, ultimately do not constitute a significant share of the Indian economy. This is coupled with the issues of agriculture still employing a large portion of the labor force mentioned earlier. The jump from an agriculture-heavy economy to a service-heavy economy without going through the manufacturing or industrial development stage is particularly difficult, if not impossible, since high-growth and high-productivity industries require a much higher level of

formal education in general (as compared to lower minimum education requirements and the possibility of on-job training in manufacturing). Bosworth and Collins (2008) noted that primary education in India had "surprisingly low" returns whereas higher education had increasing returns. Those higher returns are hardly surprising due to a heavy focus on the growth of the service sector, which had increased demand for college-educated workers. However, the lack of good primary and secondary education is a major disruption in the pipeline towards high paying urban jobs. Therefore, despite an increasing number of employment opportunities in service industries, barriers to entry were not lowered enough for mass rural-urban migration.

In terms of foreign direct investment (FDI), China's FDI inflows were sixteen times that of India — $37.5 billion compared to $2.3 billion. In fact, investment in general has been higher in China; Rao (2005) notes that China's rate of capital formation pre-reforms was "very high" at 30 percent and over. In 2020, while India invested (assuming all savings go to investments) 29.3 percent of its GDP, China invested over 44.7 percent (World Bank, 2020). India, simply put, is not creating capital (and infrastructure) at the rate it needs to for growth and replacement of obsolete capital. Therefore, its industrial sector is not growing as fast, and as established above, the transition to a service-based economy is difficult without the lack of a strong industrial sector and inadequate investment in both physical and human capital. It is important to remember, too, that physical capital is necessary for the success of all industries, not just ones that produce physical goods. The IT hub of Gurugram (formerly Gurgaon) in India's National Capital Region (NCR), for example, would not have been nearly the success that it is without the good road links it has to New Delhi and its airport.

IV. THREE POLICY SUGGESTIONS FOR THE INDIAN GOVERNMENT[1]

A. Greater Industrialization

The answer to export growth, especially in a country which has inadequate supportive infrastructure, is often considered to be export-processing zones (EPZs) and special economic zones (SEZs), hereafter jointly referred to as SEZs. Leong (2013) found out in their empirical analysis that SEZs lead to a negligible increase in the growth rate of a country, and that trade liberalization strategies are a much more significant driver of exports, and by extension, economic growth. Verick (2016) found that Indian manufacturing is more productive and less labor intensive than that of other South Asian countries, including China. This is probably an echo of the generally higher levels of labor productivity in India, which has been a primary driver of the success of its services industry, which still does not create enough jobs due to the aforementioned barriers to entry. Summarizing a key point of Amirapu and Subramanian (2015), Verick said that India never industrialized to begin with.

Therefore, the government should emphasize the due process of industrialization in its agenda going forward, without taking shortcuts (such as SEZs) or alternative routes (i.e., trying to bypass the secondary sector-led growth step). This would lead to both increased exports and growth rates — India still has the comparative advantage of low labor costs which can make exports competitive given further lowering of tariffs and NTBs, it would lead to higher employment and higher wages (and by extension, higher GDP) since manufacturing jobs could still pay more than agricultural or informal jobs. Moreover, it would be able to fill the void that currently exists due to the inadequacy of a services-dependent economy, which, despite being

[1] These policy suggestions may have various degrees of overlap.

high productivity, does not contribute as much to the economy as one would expect in a traditional developed service-based market economy.

Additionally, the timing for greater industrialization could not be better. In the post COVID-19 world, the world (especially the global North) is looking for an alternative to China for diversification of global value chains (GVCs).

B. Labor Market Reform

Labor market reforms are imperative because they go in hand with a number of other reforms. Many scholars and economists say that one of the biggest needs for growth in India is, simply, more businesses — including SMEs and MNCs. Others mention the need for increased urbanization (which is another way of stressing the need for more jobs in the secondary and tertiary sectors). Yet none of these can be achieved if labor markets are not developed further along with more social safety nets. Sankhe et al. (2020) mentioned that Indian labor markets remained inflexible and with inadequate social safety nets. They noted that labor regulations in India place a number of restrictions on manufacturing companies that stifle their ability to grow to the behemoths that become their Chinese counterparts. Another key area where reforms are needed is formalizing many jobs and parts of industries that remain part of the informal economy. This is important because of many reasons, including:

1. It can provide the government an additional avenue for revenue generation (which is required due to the fiscal deficits that it finds itself in which makes implementing much needed government spending difficult).
2. It can lead to greater transparency and accountability in those sectors by employers.

3. It can improve workers’ rights and working conditions, especially pay, which will have an effect on their living standards in general.

Obviously, formalizing jobs and sectors is not enough, and it must be led by greater reforms in the rights of workers, minimum wages, outlets for complaints, and so on.

C. Financial Sector Reform

Sources such as The Economist (2022) claim that one of the reasons why India’s growth rates disappoint (by ending up being lower than expected or fluctuating often) is due to the drawbacks of the financial and banking sectors in India. People including Patnaik and Shah (2014), and World Bank (2020), detail the need for greater reforms in the financial and banking sectors and, to some extent, fiscal reforms too.

MacDonald and Xu (2022) analyze the role played by the financial sector in growth in two ways — through the effects of cyclical financial conditions on short term growth, and through the effect of the financial sector in long-term growth. To battle the former, they say, the government must have more targeted support for firms, and have measures in place to facilitate the exit of non-viable firms. Their policy recommendations especially consider the aftermath of the COVID-19 pandemic, and what lessons can be learnt from it. To battle the latter, they stress the importance of cleaning up the balance sheets of banks and boost capitalization, particularly for private banks, which is crucial in credit growth and ultimately, GDP growth. This is also important considering the mismanagement of banks that has led to high-profile frauds such as those of Nirav Modi (read Nelson, 2021 for more details). Therefore, such policy measures

would not only strengthen the banks, but also make them more trustworthy. The World Bank's India Development Update (2020) echoes some of the issues pointed out by the aforementioned authors. It stresses the importance of eliminating structural issues such as liquidity shortages in non-bank financial companies (NBFCs) and a high level of non-performing loans (NPLs), which is important for boosting credit growth and increasing confidence and creditworthiness.

V. CONCLUSION

This paper is a mere snapshot of the differences between the Indian and Chinese economies and their development trajectories. The policy suggestions made have been simplified for brevity, and there are many aspects and details which have unfortunately not made it to the paper. Many policy suggestions, such as improvement of public services including crucial ones like water, electricity, and sanitation, did not make it to the paper due to length constraints. It is also imperative to understand that, especially in political and public policy terms, a number of policy suggestions can be made, and this is certainly not meant to be a definitive set of policy measures, but this paper does argue their importance as being some of the most important and broadly applicable measures that relate quite directly to growth in exports or economic growth in general.

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