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ECONOMIC REFORMS IN CHINA AND INDIA:
PAST AND FUTURE CHALLENGES

by Alessandro Borin* and Enrica Di Stefano*

Abstract

In China and India broad economic reforms since the 1980s progressively opened to private initiative and international trade and were key contributors to their formidable growth patterns. Today, the positive effects of past liberalizations are fading and the two countries have reached a level of development and complexity that requires a "new generation" of reforms, qualitatively more complex and politically less palatable. This paper identifies the turning points in China's and India's long phases of fast growth. It then turns to the open issues that need government action to support a sustainable and lasting growth process. In China, the priorities are to foster new growth engines by boosting domestic consumption and improving quality and efficiency on the supply side. In India, the reforms proposed by the government aim at facilitating investment, fostering innovation, protecting intellectual property, and building top-class manufacturing infrastructure. Broad reforms of financial and labor markets are also on the agenda. To make progress in these reforms both countries will require overcoming the resistance of vested interests and short term implementation costs.

JEL Classification: O20, O43, O57, P2, P3.
Keywords: economic development, transition economies, structural reforms, comparative country

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1. Economic Reforms in China

Since the late 1970s China has undergone a series of radical economic reforms, marking its transition from a closed and centrally planned economy to an increasingly open and market-oriented one. The reform process, albeit gradual and discontinuous, has proved successful in delivering a protracted period of sustained economic growth, which has lifted some 600 million people from poverty (Figure 1).

Figure 1

China's economic growth

(percentage change and ratio)

Source: Maddison, IMF-WEO

1.1 The central planning age and Mao's legacy

Prior to reforms, the Chinese economy had been following a Soviet-type planning system characterized by extensive state ownership, centrally controlled price determination and public allocation of financial and material resources. Since the first Five-Year Plan of 1953-57 the government had pursued the expansion of heavy industry as the main development strategy to transform a low-income and agrarian country into a modern industrialized economy.

The planning system delivered mixed results. The World Bank estimates that China's average per capita income growth exceeded 4 per cent per year in 1950-1975; only a few non-industrialized economies recorded better growth in the same period and most of them were oil exporters. Substantial achievements were made in some important aspects of human development such as population literacy and life expectancy (Brandt and Rawski, 2008). However, these results came at the cost of large output fluctuations, both in the primary and secondary sector, with the most serious setbacks coinciding with the Great Leap Forward Movement of the late 1950s and the Cultural Revolution of 1966-1971 (Zhao, 1988).

The implementation of these heavily distorted policies generated large-scale inefficiencies, some of which have proved long-lasting, stretching also to the reform era. This is the case of the artificial depression of interest rates and wages, designed to channel investment towards the State Owned Enterprises (SOEs)

and, in particular, towards heavy industries. As a result, the share of heavy industries in the combined total value of agriculture and industry grew from 15 per cent in 1952 to about 40 per cent in the 1970s (Chen-Yuan Tung, 2005). This could be considered as one of the legacies of the planning system that has shaped China's economic structure along the reform path until today.

1.2 Deng Xiaoping and the start of the road towards modern China

In 1978, two years after death of Mao Zedong, the new leadership of the Chinese Communist Party (CCP), headed by Deng Xiaoping, took a historical decision to 'reform and opening-up'. A number of concurrent circumstances convinced the Chinese elite that major changes in their economic structure were needed. The experience of both China and the Soviet Union led to a widespread recognition of the inefficiencies of their central planning systems, while neighbouring market-oriented economies such as Japan, South Korea and the Kuomintang-led Taiwan were experiencing vibrant economic growth. Discontent among the Chinese population after the unfortunate Cultural Revolution and a desire to improve living standards and access to essential consumption goods also played a role in inducing the Party leadership to take this decision. Since then, the transition process in China has evolved through various waves of reform that succeeding governments have undertaken in order to tackle specific economic and social problems, employing a cautious and pragmatic approach.[1]

1.3 The reforms of the late 1970s and early 1980s

The most serious failure of the planning system was probably the inability to ensure an adequate and stable food supply to the population. Besides the catastrophic famine of 1959-61 induced by the collectivization policies adopted under the Great Leap Forward Movement, food scarcity characterized the entire central planning era, especially in the rural areas. Therefore, it should come as no surprise that reforms started in the agricultural area with the implementation of the 'contract responsibility system' (1979), through which farmers were given individual plots of land and allowed to retain surplus output, rather than working only for the collective farm. This was the first of a series of measures that raised the productivity of rural areas by gradually extending property rights and promoting the development of small non-agricultural businesses. Increasing farming efficiency was also essential to ensure adequate food supply and allowed many workers to move out of traditional agriculture into higher-value-added manufacturing. Prior to the 1978 reforms, nearly four in five Chinese people worked in agriculture; by 1994, only one in two did.

The second milestone of the early reform era was the 'open-door' policy, with which China began to emerge from its isolation and to open up to international trade and foreign direct investment. China was essentially a closed economy in 1978, with a total volume of foreign trade (imports plus exports) amounting to only 7 per cent of GDP. The key measure was the establishment of special economic zones (SEZs),[2] modelled after the successful 'export processing zones' created in other Asian countries in the 1960s and 1970s. The SEZs were designed to attract foreign investment, import technologies and technical knowledge, increase exports, absorb local labour and assimilate foreign managerial and entrepreneurial skills. SEZs and other forms of industrial clusters also enjoyed favourable fiscal and administrative conditions and made crucial contributions to China's economic success (Zhihua Zeng, 2011). The very high import tariffs (56 per cent on average) were also gradually lowered; the most noticeable reduction of general tariffs, however, was not until the 1990s, when the average rate decreased from 44 per cent in 1991, to 15 per cent in 2001 (Lardy,

[1] The Chinese leadership's new philosophy toward reforms is best reflected by Deng Xiaoping's famous sentence 'It doesn't matter whether a cat is white or black; as long as it can catch mice, it is a good cat' and by the Chinese saying: 'To cross a river by feeling the stones'.

[2] In 1979 four SEZs were established: Shenzhen, across the border from Hong Kong, Zhuhai, opposite Macao, Xiamen, across from Taiwan, and Shantou, on the coast of Northern Guangdong.

2004). In addition, China progressively reduced its non-tariff barriers and relaxed most restrictions on exports.[3] The open-door policy rapidly boosted Chinese foreign trade, which reached 25 per cent of GDP by 1987.

Another important element of the reform program regarded the price system. During the early 1980s the prices of a number of commodities started to be liberalized, although they were still set administratively for most products (Oppers, 1997). A major change occurred in 1984, with the introduction of a dual-price system that allowed SOEs to sell their above-quota output at market prices. Over time, the proportion of goods allocated at market prices increased, and by the early 1990s they included almost all products.

Reforms in the financial sector started with the creation of four specialized banks in the early 1980s (Industrial and Commercial Bank of China, China Construction Bank, Agricultural Bank of China and Bank of China), that replaced the previous single-bank system, where the People's Bank of China (PBoC) served both as the central bank and as the only 'commercial' bank in the country (Caccavaio, Cristadoro and Marconi, 2013).

1.4 Reforms in the 1990s up to the accession to the WTO in 2001

The reforms of the 1980s increased the standard of living for a large part of the Chinese population; however, they also led to phases of economic and political turbulence. In the second part of the decade, while central control over prices started to ease, the expansionary macroeconomic policies pursued by the government fuelled cyclical waves of inflationary pressures, causing social discontent. Students' protests asking for greater freedom and democracy ended with the tragic events of Tiananmen square in 1989. This led to a period of conservative backlash and to a temporary stall in the reform process.

In 1992, with Deng Xiaoping's famous tour of Southern China, economic reforms regained momentum. The third plenum of the 14th Central Committee of the Communist Party of China (CCCPC) established the 'socialist market economy', paving the way for a second phase of reforms. These mainly aimed at improving the governance of SOEs, creating market institutions and converting the economy from an administratively driven economy to a price driven market economy. Between 1994 and 1995 a reform of the tax-sharing system between central and local administrations was introduced, the renminbi became convertible for current account transactions,[4] and the Commercial Banking Law and the Central Bank Law were passed, making the People's Bank of China more independent and transforming the specialized banks into commercial banks. Although the provisions of the laws regarding the banking system were only partially implemented in practice, they provided a blueprint for further reforms in this field.

In the second half of the 1990s the opening-up process gained new momentum. Trade barriers and regulations were reduced, paving the way for accession to the World Trade Organization (WTO) in December 2001. Barriers on FDI were further relaxed: in 2001 solely foreign-owned enterprises were

[3] Prior to reforms, foreign trade was conducted exclusively through 12 foreign trade companies, which had a virtual monopoly on trade, and could procure and sell goods for imports and exports at planned prices.

[4] As highlighted in the IMF Articles of Agreement (section 2a, https://www.imf.org/external/pubs/ft/aa/) current account convertibility only means that a country cannot 'impose restrictions on the making of payments and transfers for current international transactions', but it does not mean meeting all the needs of currency exchange (i.e. full convertibility, see Liu et al. 2002).

permitted,[5] and in 2002 cross-national mergers between foreign firms and Chinese state enterprises were allowed, and this opened a potential new channel to increase SOEs' efficiency.

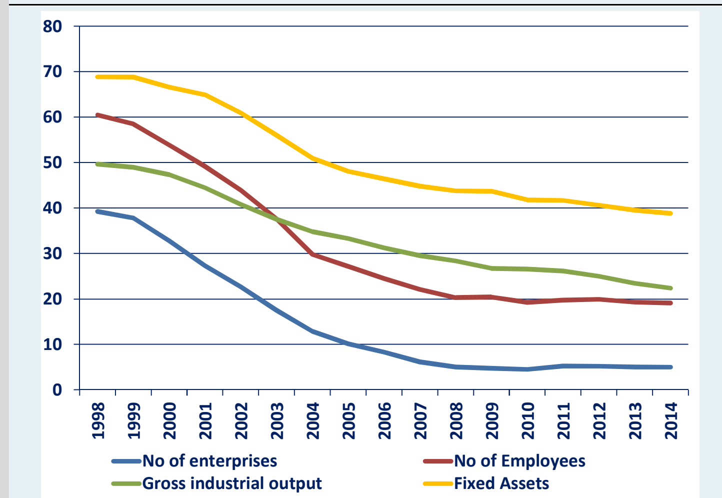
The reforms of the late 1990s focused on closing unprofitable SOEs, establishing a social security system, and dealing with insolvency in the banking system (see BOX *The reforms of the SOEs in the 1980s and 1990s*).

The reforms of the SOEs in the 1980s and 1990s

Starting in the early 1980s, state enterprises gained some autonomy in production and investment decisions. Then, in the late 1980s, a responsibility system similar to that introduced into agriculture was established,[6] allowing partial financial independence. However its incentive mechanism turned out to be ineffective in improving firms' efficiency.

Only in 1999, under the leadership of Jiang Zemin, did a broader programme of SOE reforms began. The government gave up ownership and control of small and medium- sized state enterprises through management buyouts. Large enterprises were transformed by introducing different forms of mixed (private and public) ownership, but in most cases the state retained control of the majority stake. At the same time, the reforms in the banking system enabled the SOEs' debt burden to be reduced by means of debt-equity conversions. Social obligations such as education, health care, pensions, and housing were gradually shifted off firms' books. On the one hand, this improved the efficiency and the financial condition of firms, which could now act more as market- oriented entities, but on the other hand it weakened China's welfare system, since no fully-fledged universal social security net was established.

Figure 2
Share of SOEs in China's industrial sector
(per cent of total)



Source: National Bureau of Statistics.

Since the late 1990s the share of state enterprises in the production of goods and services has been significantly reduced, while private enterprises and foreign companies have taken a leading role, especially in light manufacturing sectors. In 1998 about 40 per cent of industrial enterprises were under state control, but by 2014 their share had dropped to about 5 per cent (Figure 2). However, on average SOEs are much larger than private firms, so they still account for about one-fourth of total industrial output, a fifth of the sector's employees and 40 per cent of its physical capital stock. This composition reflects the concentration of public ownership in heavy and capital intensive industries, which are still considered strategic by the government. In sectors such as mining and energy production SOEs still account for over 90 per cent of production, and SOEs' share in other capital-intensive sectors such as steel and transport equipment production is close to 50 per cent.

[5] Before 2001, only joint ventures of foreign firms with private Chinese partners were generally allowed. Investments from solely foreign-owned enterprises were allowed only in cases where they introduced advanced technologies and/or exported most of their output (Long, 2005).

[6] After paying a fixed tax to the government having jurisdiction over it, each state enterprise was allowed to keep the remaining profit for distribution to its staff and workers and for capital investment (Chow 2004).

1.5 The 2000s

During the decade that followed China's accession to the WTO the country reaped the benefits of earlier reforms and enjoyed a period of impressive economic expansion. However, the Hu-Wen Administration that guided the country from 2003 to 2012 adopted a more conservative approach towards reforms compared with previous leaders, eventually leading to an across-the-board stagnation of the process, with a few important exceptions.

The debate on reforms returned to centre stage in the aftermath of the global financial crisis. Fearing an excessive slowdown in activity and social unrest, the authorities launched a massive policy stimulus, exacerbating the imbalances of a growth model overly reliant on exports and investment.

Two aspects of the reform process gained ground in those years: the internationalization of the renminbi and the extension of the welfare system to cover those large parts of the population that had been left without any kind of protection. This is the case, in particular, of the non-registered immigrants in the fast developing urban areas of the country, who are forced to save more of their income in order to self-insure (He et al. 2014).

1.6 Open issues and ongoing reforms

China's impressive growth outcomes over the last three decades have been to a large extent achieved through strong productivity gains, stemming from the reform process, and through high capital accumulation (Young 2003, Brandt and Rawski 2008, Knight and Ding 2010, OECD 2013). Cheremukhin et al. (2015) show that, compared to the central planning era, reforms generated more than 4 points of additional GDP growth per annum largely because of a faster growth in TFP in the non-agricultural sector and a more efficient allocation of production factors across and within sectors. According to their estimates, reforms of the pricing system and other measures that increased competition have been the main drivers of growth. Other analyses of growth accounting assign a greater role to capital accumulation during the post-reform era, although estimates vary substantially depending on the source of the data and the level of sector disaggregation.[7] However, most of the literature generally agrees on the decisive role played by the massive shift of resources from the low-productive agriculture to the secondary and tertiary sectors, which came along with the urbanization process. Di Stefano and Marconi (2015) estimate that the reallocation of production factors accounted for about 20-25 per cent of the overall labour productivity growth in 1992-2012.

The opening-up policy has been one of the cornerstones of the reform process, especially in the first stages. As a consequence, China's integration into international markets and production processes has increased remarkably. The sum of China's trade (i.e. total imports plus total exports) rose from less than 15 per cent in the early 1980s to almost 65 per cent in the years preceding the 2008 global financial crisis, with a sharp acceleration in the early 2000s after the WTO accession (it subsequently declined to 40 percent in 2015, due to the recent sharp slowdown of Chinese trade flows). The stock of inward foreign direct investment reached almost 17 per cent of GDP in 2000 from virtually zero in the pre-reform period; since then it has stabilized at around 10 per cent. In recent years China's outward investment has also taken off and the stock exceeded 8 per cent of GDP in 2015, from only 2.3 per cent in 2000.

[7] Bosworth and Collins (2008) and Perkins and Rawski (2008) estimate that TFP growth and capital accumulation have contributed more or less equally, each component accounting for about 40% of total GDP growth. Cao et al. (2009), applying the same approach and using sectoral level estimates, reduce the TFP contribution to about 25% for the period 1982-2000.

Despite these successful outcomes, sizeable misallocations of resources and inefficiencies still persist and hinder further productivity gains, threatening the continuation of the catching-up process (Hsieh and Klenow, 2009). Di Stefano and Marconi (2016) estimate that in 2010 potential gains in terms of aggregate TFP from an efficient allocation of factors ranged from 25 to 35 per cent.

Sustained high growth rates have been accompanied by the buildup of substantial external and domestic imbalances: the current account surplus widened to 10 per cent of GDP in 2007; investment's share in GDP increased from around 25 per cent in 1990 to 47 per cent in 2014, while the consumption-to-GDP ratio decreased over the same period.

Four key factor-price distortions have sustained growth but, at the same time, have exacerbated imbalances over the years: an undervalued exchange rate, low wages, low interest rates and zero - or very low - dividends paid by SOEs (Dorrucci, E. 2013, Albert et al. 2015). These conditions have artificially supported external competitiveness at the cost of depressing internal demand and household disposable income. Financial repression has forced China's households to subsidize corporate profits and high investment.

Another challenge comes from demographic transition. The one-child policy introduced in the late 1970s provided a temporary demographic dividend to economic growth (Lu and Cai, 2014, OECD, 2015). However, this is now decreasing: the working-age population is already declining as China is ageing at a much faster pace than most other countries. With health and pension costs on a rapidly increasing trajectory, there is the risk that the country is 'growing old before it gets rich' since per capita income is still only a fourth of the U.S. level on a PPP basis (14 per cent at market exchange rates in 2014).

The loss of the 'demographic dividend' makes increases in productivity critical to keep improving living standards (Lu and Cai, 2014). A more efficient allocation of resources and the upgrading of human capital are required to unlock new sources of productivity growth. This is particularly urgent at a time when export demand is slowing, and reliance on credit-financed investment has created large vulnerabilities in the fiscal, real estate, financial, and corporate sectors.

Environmental degradation, a consequence of the rapid industrialization and urbanization process, is another challenge facing the authorities. China has become the world's largest source of carbon emissions due to the rapid increase in the use of fossil fuels, especially coal. The across- the- board worsening of land, water and air pollution poses a serious threat for the population's health (World Bank, 2007).

The Chinese authorities are well aware that correcting the existing distortions requires structural reforms. These can lead the economy to a more balanced and sustainable path in the medium-long run, but may entail slower expansion in the short term (Albert et al. 2015, Gauvin and Rebillard, 2015). In 2013, under the leadership of President Xi Jinping, the Third Plenum of the CCCCP announced a comprehensive set of reforms to be implemented by 2020. The commitment to deepen reforms has recently been confirmed in the official communiqué that launched the 13th Five-Year Plan, the blueprint that should steer government policies in 2016-20 (Table 2 summarizes the main issues covered by the Third Plenum).

The objective of the Plan is to foster domestic consumption, develop new growth engines by increasing efficiency and spurring innovation as a strategy to expand into higher-value industries. This could be achieved by more market-based resource pricing, combined with a decreasing role of the state in a number of sectors.[8] It envisages significant progress in deregulation, improvement of the legal and judiciary

[8] As a symbolic move, the official statement of the Third Plenum upgraded the role of the market in resource allocation from 'basic' to 'decisive', as previously defined in official documents, and reiterated the 'push for domestic reforms

system, service sector liberalization and further opening up to international trade and FDI; liberalization and improved regulation of the financial system were also listed as crucial in order to achieve more efficient capital allocation and reduce risks of financial crisis. Other measures focused on improving the quality of the labour supply, enhancing education and labour mobility through policies in favour of migrants from rural areas and reforming the *Hukou* system.

Since 2013 the implementation process has been uneven (Table 2, third column), though it has been somewhat more successful in those areas where there was sufficient political consensus. In particular:

Financial system **-** Significant progress has been made in the liberalization of the financial system. A deposit insurance scheme was introduced in May 2015,[9] the floor on lending rates was eliminated in 2013 and the deposit rate has been freed since October 2015; nine core banks have been authorized to offer negotiable certificates of deposit, and licenses to operate in China have been granted to five new private banks. However, the transition towards a market-based financial system is still far from being accomplished. Additional reforms are needed in order to remove the existing distortions in credit allocation, such as implicit state guarantees that favour larger firms and SOEs, which tend to encourage overinvestment while leaving a large share of credit demand unsatisfied (Cristadoro *et al.* 2013, Anzoategui *et al.* 2015). These distortions are potential sources of financial instability, as attested by the surge of the shadow banking system in the aftermath of the crisis and the recurring stock market boom-bust cycles, the most recent of which was in 2014-15.[10]

Fiscal and welfare system - In recent years VAT has been extended to most services, a national property tax has been introduced and the new budget law has started to reduce the imbalance between local government spending responsibilities and revenue assignments. The 13th Five-Year Plan commits to continuing the fiscal reforms addressing inter-governmental relations but offers few details beyond what is stated in the third-plenum agenda. It stresses the importance of pension reforms[11] and of social safety nets, suggesting a number of measures (minimum wage, old-age social security, pension funds and health care, among other things). There is no detailed information on the time schedule for the implementation of these new social policies that are key for the transition to a consumption-based economy.

External sector - Renminbi internationalization and capital account liberalization have proceeded over the last few years. The international use of RMB has gradually increased since 2009, as a series of measures have opened new channels for cross-border transactions and investment in renminbi mainly through the Hong-Kong offshore market (Aizenman 2015). Following a sizeable real effective appreciation of the RMB since 2008, by the end of 2014 the exchange rate had been brought to a level that the IMF judged as being in line with fundamentals (IMF, 2015). According to the government's plan, exchange rate flexibility should further increase even though recent events have created some doubts as to the strength of this commitment, should the authorities be faced with high exchange rate volatility. In November 2015 the

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though further opening-up.' Nevertheless, the statement also reaffirmed that 'public ownership' is at the 'core' of the economic system, signalling enduring limits to the private sector's role.

[9] The insurance scheme covers deposits up to RMB 0.5 million (about €70,000), corresponding to about half of total deposits and over 99% of the accounts.

[10] Moreover, supervision and regulation seem still inadequate to govern a financial system largely driven by market forces and open to international capitals and competition

[11] China's pension systems are generally controlled by provincial or city governments, resulting in a maze of different regulations and standards that serve as a barrier to labour mobility, with elderly people often falling through the cracks. The government aims to gradually extend the retirement age and consolidate the pension system at national level, also by establishing a universal 'old-age insurance' that should cover the country's entire elderly population.

IMF announced that the RMB would be included in the Special Drawing Rights (SDR) basket in October 2016.

Since 2014 there has been continuous and gradual progress towards the opening up of the capital account, including the establishment of the Hong Kong-Shanghai Stock Connect scheme, increased quotas under various cross-border investment programs, the introduction of mutual recognition of eligible mutual funds between Hong Kong SAR and the Mainland, and the opening of the onshore repo market to offshore RMB clearing and participating banks. More recently (2015) the PBOC has also opened the onshore inter-bank foreign exchange market to foreign central banks, sovereign wealth funds and multilateral financial institutions, and has allowed more foreign institutions to invest in China's interbank bond market.

According to the 13th Five-Year Plan the capital account convertibility process should continue in the coming years. The plan highlights the rise in investment quotas for qualified foreign institutional investors (QFIIs) and increased access to China's financial services sector. The 'negative list' approach announced in the Third Plenum for FDI should be implemented, granting market access to foreign investors in all sectors except those listed as 'prohibited' or 'restricted'. Nevertheless, access is likely to remain restricted for a wide range of activities considered 'strategic' by the government.[12]

SOE reform – The reform of SOEs represents one of the most crucial areas in order to increase the efficiency and reduce the debt burden of the corporate sector. Indeed, despite their monopoly status and privileged access to resources, SOEs' profitability has deteriorated in recent years, while their financial leverage has strongly increased, especially compared with the private sector (Chivakul, M. and R. W. Lam, 2015, Barclays, 2015).

However, SOE reform is proving to be one of the most difficult to implement from a political economy perspective. While the Third Plenum blueprint had originally included goals like 'mixed-ownership', improved corporate governance and greater dividend payout, the actual reform guidelines have fallen short of these goals on many points.

The guidelines foresee the setting up of state capital management companies (SCMCs) to independently manage the government's assets and introduce an additional layer between the State-owned Assets Supervision and Administration Commission (SASAC) – whose task is to manage the state's holdings in SOEs – and the SOEs. Furthermore, large scale privatizations are not on the agenda. It is questionable whether this strategy will effectively reduce the government influence in SOEs. Mixedownership might be insufficient to significantly improve SOEs' performance, since private investors are typically powerless to enforce market discipline without a controlling stake (Bencivelli and Tonelli, 2016).

2. Economic Reforms in India

During the last 50 years India has gone through four growth phases: the 'Hindu period', with relatively low growth rates and high growth volatility that lasted up until the end of 1970s, the 1980s decade, with both high growth rates and volatility, a third phase, from around 1990 to the global financial crisis (GFF), with high growth and low volatility and the post-GFF period since 2008,[13] with slowing growth and low volatility

[12] A guideline recently issued by the State Council suggests that list of prohibited and restricted sectors could be quite large since it includes any sectors concerning 'political', 'financial', 'cultural', 'social', or other types of security, and those concerning the 'development of strategic resources' and of 'major public interest'.

[13] In the immediate aftermath of the financial crisis of 2007 most EMEs experienced limited spillovers, most often thanks to massive countercyclical measures. But after a quick recovery in 2009-2010, the slowdown was substantial, 3 percentage points less on average with respect to the average of 2000-2007. India has been no exception (see Di Stefano, Marconi, 2015).

(Figure 3). What induced the transition to the more favourable combination of growth rates and volatility observed in the 1990s? What is driving the slower growth of the post-GFF period? The answer to both questions lies in the reforms implemented in the country since the late 1970s.

2.1 The 1980s reforms: the end of the 'Hindu phase' and of the import policies

The end of the 'Hindu phase' occurred during the Fifth Five-Year Plan (1974-1979) when the annual growth rate reached 4.9 per cent, from an average of 3.6 per cent over the previous 23 years.[14] During 1981-91 the average growth reached 5.6 per cent. According to Panagariya (2003) the change in speed was induced by a number of reforms that liberalized the economy. Five liberalizing steps can be identified. First, the Open General Licensing list[15] was reintroduced in 1976 (after having disappeared earlier) and was steadily expanded; by April 1990 the list had 1,339 items on it. Second, import restrictions were eased, with a decline in the share of 'canalized imports'[16] in total imports, from 67 to 27 per cent between 1980-81 and 1986-87. Third, several export incentives were introduced or expanded. Fourth, a significant relaxation of industrial controls and related reforms began in 1985, for example, the full de-licensing of 31 industries, the introduction of an investment limit under which a licence was no longer required, the abolition of price and distribution controls on cement and aluminum, and a major reform of the VAT tax. Finally, on the monetary front, the gradual depreciation of the rupee provided a boost to exports.

While this first wave of reforms resulted in an increase in GDP growth rates, the reforms themselves were still quite limited in scope and lacked a clear roadmap. Growth during the 1980s proved fragile, highly variable from year to year and unsustainable, because it was fuelled by extensive borrowing on international markets and rising government expenditures. The external-debt-to-GDP ratio soared from 17.7 per cent in 1984-85 to 24.5 per cent in 1989-90, and the debt-service-to-exports ratio from 18 to 27 per cent. Debt quality deteriorated too. The share of private borrowers in total long-term debt increased from 28 to 41 per cent, the share of non-concessional debt rose from 42 to 54 per cent and average debt maturity declined from 27 to 20 years. Current government expenditures became unsustainable. The combined fiscal deficit at central and state levels went from an average of 8 per cent in the first half of the 1980s to 10.1 per cent in the second half. Current account deficits reached 3.5 per cent of GDP in 1990-91.

These imbalances erupted at the end of 1990, with a severe balance of payments crisis.[17] At that time the Indian government undertook a new wave of reforms that would further open up the economic system, granting a larger role to the private sector, including through foreign investment. Contrary to those of the 1980s, these reforms were systematic and well- planned, and hence able not only to maintain high growth rates but also to reduce their volatility (Figure 3).

[14] Wallack 2003 uses statistical tests on the time series of real GDP growth rates and its components and finds evidence of a structural break in 1980.

[15] After the introduction of the Open General Licence (OLG) list, tradeable goods were classified into: banned, restricted or OLG-listed. Goods in the first category were banned altogether, those in the second category would require a licence and goods in the OLG list could be imported freely.

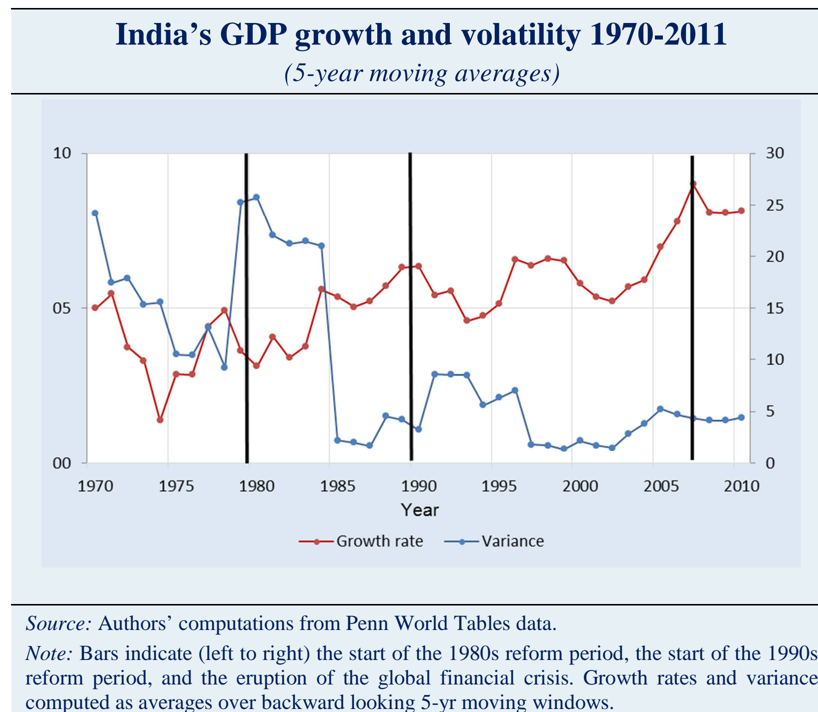
[16] Canalization refers to the government's monopoly rights for the imports of certain items.

[17] In the early '90s India still maintained a fixed exchange rate system, where the rupee was pegged to a basket of the currencies of the country's major trading partners. Already in the second half of the 1980s the rupee had started to experience downward pressures because the USSR crisis had lowered imports; later on, the surge in oil prices due to the Gulf War accelerated the balance of payments crisis at the end of 1990.

Figure 3

India's GDP growth and volatility 1970-2011

(5-year moving averages)



Source: Authors' computations from Penn World Tables data.

Note: Bars indicate (left to right) the start of the 1980s reform period, the start of the 1990s reform period, and the eruption of the global financial crisis. Growth rates and variance computed as averages over backward looking 5-yr moving windows.

2.2 The 1990s reforms: dismantling government controls on the industrial sector

In 1990 the industrial sector was still characterized by multiple controls over private investment that limited the areas in which private investors were allowed to operate and often also determined the scale of operations, the location of new investments and even the technology to be used. Moreover, to sustain the highly inefficient industrial structure, the trade policy imposed high tariffs and pervasive import restrictions.

On July 1991 the *Statement on Industrial Policy* started the dismantling of most central government controls. The reform initiatives included industrial de-licensing, opening up to foreign investment, foreign technology agreements, public sector policy and the MRTP Act (Monopolies and Restrictive Trade Practices Act). The sectors reserved to direct public control dropped from 18 to 3 (namely, defence, atomic energy and railway transportation). Industrial licensing was maintained only for hazardous, pharmaceutical and environmentally sensitive industries. Import licensing was abolished in 1993 for both capital and intermediate goods, and at the same time there was a switch to a more flexible exchange rate regime. Quantitative restrictions on imports of manufactured consumer goods and agricultural products were removed in 2001.

Tariff reduction, albeit gradual, was significant: the weighted average level of all tariffs dropped from 72.5 per cent in 1991-92 to 29 per cent in 2002-03. Foreign investors were allowed to own full property in all industries except banks, insurance companies, telecommunications and airlines. All registration schemes were abolished and licensing procedures were simplified.

India's economic performance improved significantly: in 1992-1997 average GDP growth reached 6.7 per cent and volatility decreased.[18]

[18] According to Wallack (2003) 'the data suggest that the aggregate annual growth rate [of real GDP] did increase significantly and permanently in the 1980s, but that piecemeal reforms in that decade had little discernible effect on sectoral growth rates except for faster expansion of finance, real estate and business services. The more comprehensive reforms of the 1990s appear to have contributed to faster growth in trade, transport, storage, and communication'.

2.3 Open issues and ongoing reforms

After 2000 the positive effects of the reform era gradually faded, and the global financial crisis of 2007 highlighted that several long-term structural problems persisted. To this day, India remains plagued, among other impediments to growth, by the poor quality of physical infrastructures, high poverty rates and an insufficient level of basic education. Moreover, a distortive system of energy and agricultural subsidies and strict labour market regulations contribute to distorting the allocation of capital and to reducing the mobility of labour towards more productive sectors, involving large costs in terms of aggregate productivity. Di Stefano and Marconi (2016) estimate that, from 1980 to 2010, aggregate Indian productivity could have been 35 to 40 per cent higher simply by redistributing the stocks of capital and labour across sectors in a more efficient manner.

Currently, the system of subsidies is still a significant drag on the country's economic development. Since independence, the Indian government has subsidized many industries and products, especially fuel and food, with the goal of sustaining the expenditures and living standards of low-income families. The subsidies are partially financed by state governments; the remaining part is shared by all firms in the production chain. This mechanism imposes large costs (under-recoveries) on firms, which have historically reacted by reducing investment. Moreover, since the subsidies are only granted to public companies, private ones have mostly been crowded out. Subsidies weigh heavily on public finances. They grew from 1.3 per cent of GDP in 2006-2007 to 1.9 per cent in 2012-2013, compared to 1.4 and 3 per cent allocated to health care and education, respectively. Furthermore, they are inefficient and regressive: for example, 40 per cent of gasoline is consumed by the richest 7 per cent of the population; kerosene, used for illumination, is extremely inefficient and polluting; 80 per cent of electricity production is derived from fossil fuels.

The labour market is regulated at statelevel, with 45 different Labour Laws, in a way that limits the mobility of workers across sectors. These Labour Laws apply to formal job contracts and become stricter as the size of the company increases. Firms with more than 100 workers cannot move them or change their job tasks without workers' consent. Moreover, they cannot lay off workers without the consent of local governments, which have traditionally been reluctant to grant it. Such restrictions are often bypassed by turning to informal job contracts that are extremely widespread. Informal workers represent over 90 per cent of total employment and 70 per cent in the manufacturing sector. According to several authors (Ahluwalia 2002, among others) the underdevelopment of the manufacturing sector is mainly the result of inefficient labour market regulation.

Dissatisfaction with the political leadership led to the election of a new coalition government in 2014, led by Narendra Modi, with an ambitious pro-market reform agenda that was positively assessed by international observers.

In particular, the new government has announced several initiatives to address the underdevelopment of the manufacturing sector, a particular characteristic of the Indian economy. The '*Make in India*' programme launched in 2014 was therefore aimed at facilitating investment, fostering innovation, protecting intellectual property, and building a top-class manufacturing infrastructure (see Table 3 for details). Another important reform started by Modi touches on labour market regulations. Currently, labour laws in India include a vast set of laws, administrative rules, and precedents. With respect to the legislative and supervisory bodies, the existing labour laws may be (i) enacted by the Central Government, where the Central Government has the sole responsibility for enforcement (ii) enacted by Central Government and enforced both by Central and State Governments such as the Industrial Disputes Act and the Industrial Employment (Standing Orders) Act (iii) enacted by Central Government and enforced by the State Governments such as the Trade Union Act, and (iv) enacted and enforced by the various State Governments

which only apply within those States. For laws in groups (ii) to (iv) there is a risk that workers of the same type (in terms of job description, gender and so on) are actually treated differently. Moreover, any new regulation, even if enacted at central level, may result in broad differences in the timing of implementation. In general, the difficulties in coordinating between federal and state levels translate into higher difficulties of implementing the reforms.

In 2014 some reforms were adopted in Rajasthan and Madhya Pradesh (led by Modi's ruling BJP party) and the central government is now trying to extend the experience of these states to the entire country. The proposed nationwide Labour Reform Bill would make hiring and firing easier for companies, while increasing severance payments for workers. In particular, the three key existing labour laws – the Trade Unions Act, the Industrial Disputes Act, and the Industrial Employment (Standing Orders) Act – will be merged into a single code. Furthermore, the federal labour legislation will be merged into four different codes, covering respectively wages, social security, industrial relations, and safety and welfare. However, as of April 2016 the reform proposal had not yet been approved by the Parliament.

The desirable reallocation of capital towards the more productive sectors will necessarily rely on the possibility of financing investment in those sectors through a well-functioning financial system. However, the Indian financial sector is currently dominated by public banks, which account for 70 per cent of bank lending. The role of technology has traditionally been minimal and the quality of service has not been given adequate importance. Banks also do not follow proper risk management systems and the prudential standards are weak. All these have resulted in poor asset quality and low profitability.[19] Among non-banking financial intermediaries, development finance institutions (DFIs) operated in an over-protected environment, with most of the funding coming from assured sources at concessional terms. In the insurance sector there was little competition. The mutual fund industry also suffered from a lack of competition and was long dominated by one institution, the Unit Trust of India. Non-banking Financial Companies (NBFCs) have grown rapidly, but with no regulation of their asset side. These inefficiencies were partly a result of the regulatory system. Regulation and supervision are currently carried out by different regulatory authorities. The Reserve Bank of India (RBI) regulates and supervises most of the financial system but other financial institutions and, in some cases, also the States and the Central government have competences in the area of financial sector regulation and supervision. Financial regulation in India is oriented towards product regulation, i.e. each product is regulated separately and the current work allocation between RBI, SEBI, IRDA, PFRDA, and the Forward Market Commission (FMC) has evolved over the years, with a sequence of piecemeal decisions responding each time to immediate pressures. Each regulator sets its own rules on registration, code of conduct, commissions and fees. The co-existence of multiple regulators generates several problems: first, it often leads to regulatory arbitrage, second, it creates gaps, i.e. areas where no regulator is in charge and third, it produces conflicts between regulators, since laws and agencies sometimes overlap.

A number of financial sector reforms in India were introduced with the economic reforms of the 1990s but the global financial crisis has provided a renewed impetus. A new generation of reforms has focused on (i) adherence to international standards, especially through the implementation of G20 commitments (ii) development measures and (iii) stability measures. A Financial Sector Legislative Reforms Commission (FSLRC) was set up by the Ministry of Finance in March 2011 and presented its recommendations in March 2013 (see box for details). The implementation of the Commission's recommendations is ongoing. The process should, at some point in the future, lead to Parliament enacting an Indian Financial Code. Meanwhile, institutional capacity is being created so that when Parliament passes the law, it can immediately be enforced. At present, several task forces are working to establish the Financial Sector Appellate Tribunal (FSAT), which will hear appeals against all existing financial agencies, the Public

[19] For a detailed analysis of the problems and issues of the Indian banking sector see Furgeri (2016).

Debt Management Agency (PDMA), the Resolution Corporation (RC), the Financial Data Management Centre (FDMC), and the Task Force for the Financial Redress Agency. The last of these started to operate in June 2015.

The recommendations of the Financial Sector Legislative Reforms Commission to reform the financial system.

The FSLRC presented its Report to the Finance Minister in March, 2013. The most important recommendations include (i) the decision to merge the roles of the Securities and Exchange Board of India, the Forward Markets Commission, the Insurance Regulatory and Development Authority, and the Pension Fund Regulatory and Development Authority into a single regulator called the 'Unified Financial Agency' (UFA), on the grounds that all financial activity other than banking and the payments system, which would continue to be regulated by the Reserve Bank of India (RBI), should be brought under a single authority, (ii) the continuation of the Financial Stability Development Council (FSDC) with the mandate to monitor and address systemic risk, which is to be led by the finance ministry, (iii) the creation of a Resolution Corporation that would identify institutions that are threatened by insolvency and resolve problems at an early stage and (iv) the creation of a Public Debt Management Agency that would take the responsibility of public debt management away from the RBI.

Despite the reform steps described above, in recent years the banking sector has experienced a surge in non-performing loans, thus limiting their ability to fund *any* investment, including the most productive ones. In 2015 the ratio of non-performing assets to total advances increased, despite a marginal decline in restructured loans. Taken together, the ratio of stressed advances currently exceeds 11 per cent of total loans. In 2015 the government and the central bank moved to revitalize public sector banks by recapitalizing selected banks, allowing others to raise capital from markets (thereby diluting the government's holdings), and improving governance by appointing executives according to professional and transparent criteria. Moreover, bank lenders were given the option to convert their loans into equity in borrower's companies under a specified pricing formula to collectively become majority shareholders. In December 2015 a bankruptcy law was proposed that would substantially improve the quality and speed of debt restructuring. Finally, the central bank has undertaken several measures to strengthen non-performing loan disclosure, risk control procedures and the appointment process for public banks' management. Taken together, these measures could gradually help unclog banks' finance channels and support private sector spending on investment.

3. Additional considerations and concluding remarks

During the last three decades China and India have experienced a formidable growth performance, propelled by a sequence of reform waves since the late seventies. These measures have removed a number of distortions, opening up the two economies to private initiative and to international trade. Production factors have been progressively reallocated from low-productivity sectors and regions to high-productivity activities, and the economic structure has been upgraded. The more efficient allocation of resources and the increase in capital endowment through domestic and foreign investment have boosted labour productivity and real wages. Both countries have thus achieved 'middle-income' status, with China joining the narrower group of 'upper-middle-income economies', as defined by the World Bank.

Currently the two countries face similar challenges. The positive effects of past liberalizations are fading, and new imbalances have accumulated within the economies, while some old frictions and distortions still persist. The external environment has become less favourable, with weaker foreign demand and greater competition from other emerging economies coming to the global fore.

China and India have probably reached a level of development and complexity that requires 'a new generation' of reforms, qualitatively more complex and politically less palatable. In fact, as pointed out by Jun (2014), the growth strategies that lift a poor country to middle-income levels might be inadequate to

propel it to high-income status. History provides a number of examples of countries that have not been able to change gear, getting stuck in the 'middle-income trap'.

Although each country that has succeeded in entering the high-income club followed its own transformation process, all rich countries share one common feature, namely, a high level of institutional quality. The evidence on the association between high output per capita and good institutions is overwhelming in the literature (*e.g.* Hall and Jones 1999, Acemoglu, Johnson and Robinson 2001, North, Wallis and Weingast 2009, Witt 2016). In particular, the different aspects of the rule of law – from security of person and property rights to checks on governments and control of corruption – appear essential to create a business environment in which more sophisticated activities can flourish. This ensures that firms have the right incentives to compete and innovate, that financial markets channel resources to more productive activities and that managerial and technical skills are adequately rewarded (Przeworski 2004).

Summers and Pritchett (2014) and Jun (2014) highlight that temporary departures from this powerful empirical relationship are usually explained by a divergence between *de jure* laws and regulations and the *de facto* outcomes for specific firms. In particular, authoritarian governments might be able to create transitional institutional arrangements that provide a high and secure profitability for firms without the neutral enforcement of the rule of law. The rise of Taiwan and South Korea after World War II occurred under these conditions, which have been largely shared also by post-reform China. To some extent, the high level of corruption in India has also played a similar role for some favoured firms. Indeed, Shleifer and Vishny (1993) have long argued that organized corruption need not be inimical to growth in some stages of development since 'grease money' could accelerate the tedious procedures of bureaucracy (Kaufmann and Wei 1999, Fishman and Svensson 2007), but there is evidence that it is a drag on growth for middle-high income economies (De Rosa, 2010, Gamberoni et al. 2016).

While an environment characterized by 'closed ordered deals' (as defined by Hallward-Driemeier et al. 2016, deals that are ordered - in that they are roughly predictable both ex ante and ex post - but which are 'closed' in that they are only available to some firms) might provide a favourable environment during the initial phases of the catching-up process, it is probably inadequate for ruling the complex business environment that characterizes advanced countries. China and India score quite poorly in international rankings that evaluate the quality of institutions, and in recent years have not seen a significant reduction of the gap with high productivity countries.

Both the reform programs launched by the Xi Jinping administration in China and those launched by the Modi government in India include a number of measures that might provide a significant contribution to improving the quality of institutions. However, the resistance of vested interests and the weight of short-term implementation costs constitute strong headwinds against the progress of these reforms, both in China and India. Moreover, in the case of China, it seems implausible that a transition from the rule of power to the rule of law can occur without making any progress in the democratization process. Indeed, the success of South Korea in reaching high-income status seems closely associated with its political transformation into a full democracy during the 1980s.

The strengthening of institutions should be the centrepiece of the upgraded growth strategies in China and India to stimulate technological progress and structural transformation. Otherwise, high-income status will probably continue to elude the two Asian giants.

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Table 1

Landmark dates of China’s economic reforms in 1978-2012	
1978	At the Third Plenum of the CCP Eleventh Party Congress on December 18-22 Deng Xiaoping launches reforms backed by the recently rehabilitated veteran leader. China adopts the household responsibility system in agriculture, giving some farmers ownership of their product for the first time.
1979	‘Open door’ policy initiated, foreign trade and investment reforms begin. Law on Joint Venture Companies passed
1979	Three specialized banks separated from the People’s Bank (the central bank).
1980	First four special economic zones created
1984	Tax for Profit reforms of SOEs
1986	Provisional bankruptcy law passed for SOEs
1987	Contract responsibility system introduced into SOEs
1988	Economic turbulence stirs public discontent. Bank runs and panic buying are triggered by rising inflation that peaks at over 30 per cent in cities.
1989	Tiananmen square events trigger retrenchment policy, halt on reforms
1990	Stock exchange opened in Shenzhen, Shanghai
1992	Deng Xiaoping’s ‘Tour through the South’ reignites reforms. This sparks a fresh wave of market growth and some political relaxation.
1993	Decision of the third plenum of the CCCPC of the 14th party congress to establish a ‘socialist market economy’ paving the way for fiscal, financial and SOE reforms
1994	RMB convertible for current account transactions
1994	Tax-sharing system reforms introduced
1994	Policy banks established, commercialization of banking system announced
1995	Central Bank Law, Banking Law and Budget Law enacted
1997	Comprehensive plan to restructure SOEs adopted, ‘grab the big, let go of the small’
2001	China joins the World Trade Organization in November.
2003	3rd CCCPC plenum of the 16th party congress, decision to ‘perfect’ the socialist market economy
2003	Rural health insurance scheme re-established (called new rural cooperative medical scheme – NCMS)
2004	Constitution amended to guarantee private property rights
2005	Renminbi depegged from U.S. dollar and switched to a managed floating regime
2007	The urban resident basic medical insurance (URBMI) was developed
2009	Introduction of renminbi settlement for cross-border trade transactions
2011	ODI and FDI settlement in RMB is introduced
2013	On August 2013, the State Council approved the establishment of the Shanghai Free-Trade Zone
2013	The 18th Third Plenum of the Central Committee of the CCP adopts the decision to deepen the reform comprehensively
2014	Fiscal reforms including expansion of VAT to services.
2014	Financial administration reform, including a pilot program for local bond issuance
2015	Bank deposit and lending rates are fully liberalized

Table 2

***Third Plenum* reform programme: planning and progress**		
Field	**Planned reforms**	**Reform progress since the Third Plenum**
Market liberalization and reduction of public intervention	- liberalization of input prices (electricity, gas, water); - SOE reforms: encouraging private investment in state-owned enterprises (SOEs); separating the management of state capital from daily business operations; raising SOE dividend payout ratios to 30% by 2020; - government role to be focused on the provision of public services; - liberalization of activities (especially in service sectors), suppression of state monopolies (except for natural monopolies that should be regulated); - enhancing the legal system, property rights' protection and the rule of law.	- reduction in the government's setting prices in energy, healthcare and transportation - pilots of state-owned capital investment companies launched; - share of mixed- ownership firms in industry risen by 12%; - SOE dividend payout ratio raised by 5 percentage points to up to 25%.
Financial system	- interest rate liberalization; - introduction of a deposit insurance scheme - encourage the market entry of privately-run and foreign-run banks;	- deposit insurance scheme launched; - fully liberalized deposit and lending rates; - loan-to-deposit ratio scrapped.
Opening up	- capital account liberalization - exchange rate flexibility - FDI liberalization adopting a negative list approach - establishment of Free Trade Areas	- RMB fixing mechanism has been made more market driven; - restrictions on offshore borrowing and outbound investment relaxed; - qualified investors (QFII & RQFII) quotas expanded. - restriction relaxed in Shanghai Free Trade Zone
Fiscal and public finance reforms	- improving fiscal transparency and revenue sharing between local and central governments; - increase the proportion of direct taxes; - extending VAT to the service sector; - increasing taxes on polluting activities and high-end goods;	- new budget rules allowing local governments to borrow directly and bringing financing vehicle debt on budget. - property registration system launched as groundwork for property tax. - VAT expanded to cover transport, post & telecommunications sectors.
Social welfare, income inequality and urbanization	- social spending centralization (eg. in education) and creation of universal coverage social security systems - establishing a basic national health system covering urban and rural areas - extend rural reforms by allowing rural land to be sold, transferred and leased. - accelerate 'Hukou' system reform.	- medical insurance and pension schemes made more generous and coverage expanded; - unification of rural and urban pension schemes
Other social and institutional reforms	- relaxation of the one-child policy; - abolition of forced labour.	- switch to a two-child policy

Table 3

Initiatives under the "Make in India" program
• Easing doing business in India – new delicensing and deregulation measures.
• Process of applying for Industrial License & Industrial Entrepreneur Memorandum made online on 24×7 basis through eBiz.
• Validity of Industrial licence extended to three years.
• States asked to introduce self-certification and third party certification under the Boilers Act.
• Major components of defence products' list excluded from industrial licensing.
• Dual- use items having military as well as civilian applications deregulated.
• Services of all Central Government Departments & Ministries will be integrated with eBiz.
• Process of obtaining environmental clearances carried out online.
• Following advisories sent to all Departments/ State Governments to simplify and rationalize the regulatory environment.
• All returns filed on-line using a unified form.
• A check-list of required compliances to be placed on the Ministry's/Department's web portal.
• All registers required to be maintained by businesses to be replaced with a single electronic register.
• No inspection to be undertaken without the approval of the Head of the Department.
• A system of self-certification to be introduced for all non-risk, non-hazardous businesses.
• Youth-focused programs and institutions dedicated to developing specialized skills.
• 'National Industrial Corridor Development Authority' is being created to coordinate the development of Industrial Corridors.
• Work on 5 smart cities in progress as part of the Delhi-Mumbai Industrial Corridor: Dholera, Shendra-Bidkin, Greater Noida , Ujjain and Gurgaon .
• Chennai-Bengaluru Industrial Corridor: master planning for 3 new Industrial Nodes [Ponneri (TN), Krishnapatnam (AP), Tumkur (Karnataka)] in progress.
• The East Coast Economic Corridor (ECEC) with the Chennai-Vizag Industrial Corridor as the first phase of this project: Feasibility Study commissioned by ADB.
• Amritsar-Kolkata Industrial Corridor: DMICDC selected as Nodal Agency for doing a Feasibility Study.
• North-eastern part of India to be linked with other Industrial corridors in cooperation with the government in Japan.
• New Industrial Clusters for promoting advanced practices in manufacturing.
• Approval accorded to 21 Industrial projects under the Modified Industrial Infrastructure Upgrading Scheme with an emphasis on: (1) use of recycled water through zero liquid discharging systems and (2) central Effluent Treatment plants
• Approval accorded to 17 National Investment and Manufacturing zones.
• Strengthening of the Intellectual Property regime
• Support for skills development through Indian Leather Development Programme: (1) youth training and (2)fFunding of 4 new branches of Footwear Design & Development Institute.
• Policy for the Defence sector to be liberalized and FDI cap to be raised from 26% to 49%.
• Portfolio investment in Defence sector permitted up to 24% under the automatic route.
• 100% FDI allowed in Defence sector for modern and state- of- the- art technology on a case- by-case basis.
• 100% FDI under the automatic route permitted in construction, operation and maintenance in specified ril infrastructure projects such as: (1) suburban corridor projects through PPP, (2) high speed train projects, (3) dedicated freight lines, (4) rolling stock including train sets and locomotives/coaches manufacturing and maintenance facilities, (5) railway electrification, (6) signaling systems, (7) fFreight terminals, (8)passenger terminals, (9) infrastructure in industrial parks pertaining to railway lines/sidings including electrified railway lines and connectivity to main railway lines and (10) Mass Rapid Transport Systems
• Easing of the norms underway for FDI in the construction development sector.