

(The current session is entitled: Freedom versus Authority: What path to development? The below is an extended version of the talk that will be delivered at the conference.)

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The phrase that clearly stands out is the juxtaposition of ‘Freedom’ with ‘Authority’ – of China’s authoritarian model to India’s ‘democratic model’. When Milton Friedman was asked about this in an interview with the WSJ in July 2006 about the contrast between the two, he replied:

“China has maintained political and human collectivism while gradually freeing the economic market. This has so far been successful but is heading for a clash, since economic freedom and political collectivism are not compatible. India maintained political democracy while running a collectivist economy. It is now unwinding the latter, which will strengthen freedoms of all kind, so in this respect it is in a better position than China.”

Is Friedman right, and if so, why is he correct? Note that Friedman is not simply echoing the so-called ‘modernisation’ thesis that democracy will eventually come to China; he is saying that democratic India has a better model of political-economy than authoritarian China.

The term ‘development’ has been monopolized by economists for several generations. But in understanding the development of one’s political-economy and in assessing Friedman’s thesis, I think those during the Enlightenment would have tweaked the question to ask not just about ‘paths toward development’ but alternative paths toward ‘modernity’ – which includes economic development – but much else besides. This makes sense because assessing the economic prospect for China and India is about more than simply comparing the short-term drivers of GDP growth in the country. I therefore want to ask how the political-economies of China and India are winding their way towards ‘modernity’.

The sociologist Anthony Giddens believes that modern society, or what he calls an ‘industrial civilization’ is associated with three things: 1. An idea of the world as open to transformation by human intervention; 2. A complex set of economic institutions, namely a market economy; and 3. Political institutions that buttress the first two elements within the framework of a nation-state, namely democratic institutions.

Clearly, no sociologist (even one as great as Gibbons) has the last word on what modernity and developmental progress means. Gibbons’ views have legitimately

relied on history since the Enlightenment. His summation – correct from a historical point of view - is that the preeminence of individual economic and political rights is the accomplishment of the modern era – inextricably tied in with the sacredness of property rights and the right of an individual (person or firm) to engage in a market economy in a rule-of-law environment.

What would a thinker like Hayek say about developmental ‘progress’ – and about China and India’s path towards modernity?

On the one hand, Hayek would affirm Giddens’ view that a market economy supported by liberal-democratic institutions best embody progress in its most practical, tangible, and effective form. In this sense, he would not disagree about Giddens’ interpretation of recent history.

Yet, Hayek’s contribution and genius was not just about being on the right side of history but in building a methodology to explain why one approach would be on the right or wrong side of history. For example, Hayek never begins from the premise that democracy is, *a priori*, the best and ideal form of government. He is a democrat because democracy came about due to the demand by individuals to be actively involved in making decisions for his or her life, and in doing so, give value and effect to the subjectivity and multiplicity of choices for themselves that individuals make.

In other words, Hayek would be more concerned with methodology and process than prescribing the desired end state. The history of human activity – including economics – is the process of individuals striving to solve their problems, and relying on falsifiable knowledge and limited rationality in doing so. Just as socialism errs by relying on a small number of people to be in possession of all the bits of information that one must have to make good decisions for the rest of society – a ‘mastermind’ that does not exist in practice or anywhere in reality – any *a priori* claim that one developmental model of political-economy is better than another for a particular country should be greeted with skepticism.

Therefore, thinkers such as Hayek reject that there is a universal and timeless definition of political notions such as the ‘common good’, or economic notions such as ‘objective value’. They would similarly reject a rigid ‘historicism’ – the idea that there are objective and unchanging laws of historical development and progress in human history: ranging from Marxist historical materialism to Fukuyama’s ‘end of history’ idea that liberal democracy is the *necessarily* the *inevitable* and *ethical* end-state of human history (even as Hayek remains a stout

defender of the desirability of liberal-democracy.) Hence, the mere fact that China is currently committed to an authoritarian model, while India retains its democratic one, does not in itself tell us whether one will be more effective and successful than the other.

Why invoke thinkers such as Hayek in talking about ‘alternative paths’ toward modernity and development? One superficial reason is because I am speaking at a Mont Pelerin Society meeting. But the more important reason is that thinkers like Hayek usefully focus on methodology and process rather than doctrine, ideology or end-states. This is critical because any China versus India comparison needs to go beyond joining the cheer-squad of democratic development on one side, or authoritarian development on the other. We need to ask why one version offers decisive advantages over another; and it is for this reason that the methodology of thinkers such as Hayek is invaluable.

While Hayek avoids the trap of preordaining one preferred end-state over another, neither does he subscribe to an ‘anything is OK’ position, or the belief that assessment of different systems is methodologically impossible. A primary concern of Hayek is to make the best use of the sum of individual human (and a firm’s) knowledge. In doing so, his famous essay ‘Economics and Knowledge’ sketches an account of a society built from and sustained by a large variety of practical, local ‘bits of information’ and ‘dispersed insights’ which cannot be centrally controlled, prescribed or mediated. As he puts it:

“The peculiar character of the problem of a rational economic order is determined precisely by the fact that the knowledge of the circumstances of which we must make use never exists in concentrated or integrated form but solely as the dispersed bits of incomplete and frequently contradictory knowledge which all the separate individuals possess.”¹

In doing so, he lauds the virtue of a productive and ever-changing ‘spontaneous order’ as a mark of progress. The inability of socialism – which relies on central planning and prescribed distribution of resources - to effectively coordinate and give effect to invaluable conglomerate of ‘bits of information’ and ‘disperse insights’ is central to its flaws.

For the purposes of this presentation, these insights provide the skeleton of a useful framework to assess the alternative Chinese and India approaches to modernity and development. Modernity, progress and development is not about the current or end state of the Chinese and Indian political-economies. It is about comparing which

model best coordinates and integrates the diverse sources and kinds of information; which model is creating the better marketplace for the creation, multiplication, harvesting and use of diverse knowledge and insights in a productive way. The one doing so is subsequently better placed to generate *a productive, stable and adaptive 'spontaneous order' that is a mark of progress and modernity.*

In comparing the Chinese and Indian approach, I propose two ways to approach the issue.

First, to what extent does 'evolution' take place within the Chinese and Indian political-economies? 'Evolution' does not just mean changing. It is about progress - how knowledge within these political-economies is encouraged, created, used and entrenched to improve the model. For example, in an article on 'evolutionary economics' by Jason Potts, he explained how some ideas (including mechanisms and processes) are tested and found reliable or useful, and others are similarly tested or rejected. For evolution to work, *selection* mechanisms to test new solutions for existing problems must arise. The worse solutions are eliminated and the better ones are *replicated*. In turn, *variations* of these better solutions offer new approaches. This is at the center of any approach that is premised on the capacity of human intervention to achieve progress.

Historically, liberal-democracies with free markets have done this best. They have served as a mechanism that structures the process of knowledge growth, and allowed these structures to adapt. The wider and more effective the market (and the way it operates) the greater the possibilities for learning, specialization, and adaptation. For our purposes, it is largely this growth of knowledge – this evolutionary process- that ultimately drives progress and the path toward modernity – and development. The issue is whether the Chinese and Indian models share this evolutionary virtue.

Second, what is the relationship between the rulers and the ruled in these two countries? More precisely, what is the relationship between the rulers (and the sources of government power and influence) on the one hand and domestic political, economic and social entities (that are competing with sources of government power and influence) on the other? The question is important because it offers an insight into the *structural barriers* that might significantly impede the operation of a sound evolutionary system. Evolutionary change in this social-economic-political context invariably involves a model that can effectively make best use of contest and competition. This means determining and resolving the

relationship between the rulers and the ruled is at the center of in any trajectory towards progress and modernity.

Capitalism with Chinese characteristics: therapeutic but not transformative

Ever since Deng Xiaoping describe the Chinese model as ‘crossing the river by feeling for the stones,’ and urged the Chinese Communist Party (CCP) to ‘seek truth from facts’, many observers are convinced that Beijing has taken a pragmatic, gradual, experimental and evidence-based approach to reform – seemingly the very essence of an evolutionary based approach. Spectacular growth rates have given additional credibility to this viewpoint, with growing numbers convinced that the authoritarian regime is ruthless but clear-sighted and competent.

Yet, I argue that the modern Chinese approach is only a superficial version of a successfully evolving model because ongoing evolution is limited by the state’s immense and predatory role in the economy, a subsequent lack of necessary institutions needed to continually evolve, and a failure (or refusal) to adequately negotiate the question of the relationship between the rulers and the ruled.

The modern reform period began under Deng Xiaoping in December, 1978. Because the Chinese economy has been growing constantly for three decades, there is the common belief that China has been gradually but steadily reforming into a free market economy over 30 years. But in fact there have really been two distinct reform periods driven by two distinct reform philosophies since 1978: the pre-Tiananmen period from 1978-1989 and the post-Tiananmen period from 1991-present.ⁱⁱ

Prior to 1989 the unplanned spontaneous explosion of private initiative in rural China – fuelled by limited land reforms – was encouraged by officials and even supported by government policy. This was a period Yasheng Huang called the ‘entrepreneurial decade’. Farmers were encouraged to make their own decisions for how they wanted to use their plot (even if it was still owned by the state) and allowed to sell their produce at market prices after meeting production quotas. A happy accident of the limited land reforms were the spontaneous rise of small scale businesses known as ‘Township and Village Enterprises’ in rural China providing meaningful employment for over 100 million Chinese peasants. Significantly, during this decade, mean wages and incomes were rising at the same rate or faster than GDP growth. An independent ‘middle class’ was emerging in China. Indeed, 80% of the poverty alleviation that occurred since 1979 was achieved during this

ten year period. (Since then, Chinese rates of poverty alleviation are very similar to what India has achieved since the early 1990s.)

These early experiences proved that individual and entrepreneurial activity could successfully take root in China despite the decades of turmoil and socialist experimentation. Capital followed learning, local knowledge, and enterprise, while officials facilitate this process or else got out of its way. As Kate Zhou puts it, the developments were a “spontaneous, unorganized, leaderless, non-ideological, apolitical movement.”ⁱⁱⁱ Even Deng admitted “The result was not anything I or any other of the other comrades had foreseen. It just came out of the blue.”^{iv} A little known fact is that 75-80 percent of the Chinese that emerged out of poverty since 1978 did so in the first decade of reform – when the spontaneous bottom-up transformation in rural China took place - not more recently as many assume.

After the Tiananmen protests, China deliberately and decisively changed tack. The Tiananmen protests – which actually saw thousands of protests spring up in hundreds of cities involving millions of people - brought the CCP to its knees. During the ‘Tiananmen Interlude’, the CCP nervously watched the fall of the Berlin Wall followed by the implosion of the Soviet Union. It realized that authoritarian regimes become irrelevant at their peril. To preserve its relevance, the CCP expended extensive efforts to retake control of the major levers of economic power. This control today is at the heart of an economic structure that entrenches, for the moment, the role and status of Party officials and members in Chinese economy and society. The story of China’s economic rise since the 1990s is mainly a story about the rise of the ‘corporate state’ and the emergence of a ‘state-led’ model of development – not the flowering of its private sector. Unfortunately, it is now the CCP’s determination to hold on to political, economic and social power that is behind many of China’s most serious problems and why these are becoming worse.

Behind China’s current ‘economic miracle’

Even before the current global financial crisis, at the National People’s Congress in March 2007, the annual meeting of the State’s highest body, current Premier Wen Jiabao offered his country a warning, declaring that “the biggest problem with China’s economy is that growth is unstable, unbalanced, uncoordinated and unsustainable.” This was all but reiterated by President Hu Jintao at the five-yearly Congress in Beijing in October 2007, and repeated again this year. Similar warnings have been issued since the late 1990s.

Although growth remains robust, it tells only a small part of the story and how China is faring. There are serious flaws to the Chinese economic growth strategy an methodology emerging, particularly since the 1990s. Indeed, in recent times, its high level of growth is somewhat symptomatic of the problem.

How has China achieved growth since the 1990s? Most Western commentators focus on the spectacular success of China's export sector and the emergence of China as the world's factory. But the greater contributor to Chinese growth is actually domestically funded fixed-investment which constituted over 50% of GDP in 2008 and over 40% of growth in that year. In 2009, due to the massive stimulus order by the government, between 80-90% of growth is a result of capital investment. To put China's growing addiction to loans from state-owned banks in perspective, its banks lent out US\$150 billion in 2001, US\$380 billion in 2003, US\$750 billion in 2008, and US\$1,130 billion in the first 7 months of 2009 alone.^v In other words, growth is largely the result of state-controlled entities pouring money into fixed investment projects.

But it is not just the high reliance on fixed-investment that is striking. It is where the capital goes that is all important. China is unusual in that bank loans – drawn from the deposits of its citizens funneled into state-controlled banks - constitute around 80% of all investment activity in the country. Even though state-controlled enterprises produce between one quarter and one third of all output in the country, they receive over 75% of the country's capital, and the figure is rising. State-controlled companies received well over 95% of the recent stimulus monies lent out in 2008-9. The Chinese state sector owns over two thirds of all fixed assets in the country. This is the reverse of what occurred in China during the first ten years of reform where private sector businesses received over 70% of all the country's capital.

The massive bias toward the state sector would be acceptable if the 120,000 state-controlled enterprises and their countless subsidiaries could learn to innovate and adapt. Unfortunately, except for a handful of centrally managed state-controlled enterprises, this is not the case. According to one expert, 19 percent of state-controlled enterprises were unprofitable in 1978, 40 percent were unprofitable in 1997, rising to 51 percent being unprofitable in 2006.^{vi} A conservatively estimated 40 percent of bank loans to these entities are extended on a 'policy' rather than 'commercial' basis while most loans to state-controlled enterprises are afforded artificially low interest rates.^{vii} Banks are effectively fulfilling the political priorities of the government through their 'policy lending' function: to maintain jobs for state-controlled enterprise workers who are the Party's most loyal

supporters, to maintain support for state-controlled enterprise managers who are core Party members and supporters, and to maintain growth in ‘middle class’ and urban areas at any cost since the Party needs the continual support of the new and emerging middle classes to survive. As Zhang Hanya, a senior researcher at Beijing’s National Development and Reform Commission's Investment Research Institute in 2007, a full year before the global financial crisis, China needs to keep fixed investment growth levels at around 25 percent per annum just to *maintain* present levels of employment.^{viii}

This is all leading to a worsening bad loans problem – mostly hidden in the balance sheets of local SOEs (and therefore local bank branches) - which has been manifest since the early 1990s. The balance sheets of these banks are superficially healthy but they are only able to operate due to periodic bail-outs by the government (in which bad loans are transferred to ‘asset management companies’,) and bad loans are removed from balance sheets only due to stipulations that maturing loans be ‘rolled over’ since they cannot be paid back. They remain liquid mainly due to the high savings of the population being deposited in these banks – alongside almost perfect capture of the country’s savings - as there are few options outside state-controlled banks in China.

Far from a healthy evolutionary process of selection, replication and variation driving China’s authoritarian economics, recent instances of economic reform have been largely tactical to plug obvious holes rather than comprehensive. After all, despite overwhelming evidence that heavily protected state-controlled enterprises use capital poorly, they have been receiving a constantly rising share of the country’s wealth which is being largely denied to China’s millions of private businesses – most of which remain small and heavily hamstrung by lack of access to capital. Importantly, these private enterprises use capital between 2-3 times more efficiently and are twice as efficient in generating employment. Yet, supporting the continued rise of the corporate state will continue since the CCP will not want to dilute its economic power despite the enormous cost to the country.

Even for the piecemeal reform that has occurred, it runs into the enormous problem of poor or non-existent implementation. Western experts visiting China generally go away impressed with the competency of its senior officials. But functional authority in China is largely decentralized. Around 45 million provincial and local officials – compared to less than one million central officials - exist in a largely unaccountable environment due to the lack of effective institutions for public accountability within the one-Party set-up. These local officials oversee, regulate,

and administer almost all economic and enforcement activity in the country. China's central leaders have consistently run into problems in terms of enforcing its mandates and regulations.

This leads to the enormous problem of corruption, particularly at the local levels, which is systematic, profound and embedded throughout every level of Chinese economy and society. Estimates are that direct theft of state resources amount to around 2% of GDP each year, while the 'indirect' economic cost of corruption is estimated by various Chinese researchers to be up to 17 percent of GDP.

Moreover, while it is true that China's well known environmental problems is the result of rapid growth, these problems are also significantly caused by, and made worse, by poor adherence to even minimal environmental standards and edicts on the part of local officials who are rewarded for achieving growth no matter the cost. Given the lack of institutions and other mechanisms of accountability, standards imposed by Beijing are regularly ignored.

Yet, China's central leaders have little choice but to continue to support local officials in order to prolong the survival of the CCP as rulers. In a vast country of 1.3 billion people, Beijing relies on the 45 million local Party officials to represent its authority and preserve the CCP's interests. Local CCP leaders have a huge informational advantage over the central leadership; the latter have few alternate sources of information other than what local authorities reveal. Importantly, even national law, economic and even social order policies – as well as centrally instituted fiscal policy - are necessarily executed by local officials.

Beijing's own warnings that its economic model is becoming dangerously dependent on ever increasing levels of inefficient capital investment to achieve growth can only be solved if greater support is given to China's private businesses – allowing the spontaneous bottom-up explosion of enterprise to take place in the private corporate sector that began in rural China in the 1980. This would mean the much more efficient use of capital, the creation of more jobs, and a rise in private rather than just state wealth. This would increase domestic consumption needed to rebalance the economy - current around 30-35% of GDP which is the lowest of any major economy in the world - and re-orientate its growth model toward a more sustainable approach.

However, leaders from Deng Xiaoping onwards see the use of tactical 'reform' as a mechanism to remain in power rather than to accelerate the loss of it. Insistence that the Chinese 'corporate state' grow stronger rather than weaker is absolute. The problems are neither just cyclical or a temporary hitch as China confronts the

enormous task of development. The suppression of China's evolutionary drivers – rational selection, replication, and adaptive variation - is serious, chronic, and systemic.

Rich and strong state... poor people and weak civil society

It is not just about economic numbers. As mentioned, another way to assess progress is to look at the relationship between the rulers and the ruled, and how the government responds to domestic forms of political, economic and social competition and disagreement. One major problem for China is that too heavy an emphasis on state-led development tends to exacerbate inequality as the economy expands. Since the state dispenses the most valued business, career and professional opportunities, a relatively small group of well placed and well connected insiders benefit while opportunities to prosper are denied to the vast majority. Unlike the pre-Tiananmen period, mean wages and income throughout the country have been rising three to four times slower than economic growth.

This is certainly a serious problem for Chinese society. Its Gini coefficient, a measurement of income inequality,^{ix} rose from around 0.25 in the 1980s to around 0.38 in the 1990s.^x It is now around 0.55^{xi} which is the highest in Asia. Worryingly for China, despite enormous GDP growth, about 400 million people have seen their incomes stagnate or decline during the past decade.^{xii} Another study by the World Bank suggests that the income of the poorest 10% was declining by 2.4% each year at the beginning of this century.^{xiii} Since 2000, absolute poverty has actually increased as has illiteracy. Combined with the absence of social safety nets such as healthcare, it is no wonder the consumption levels of Chinese – at 30% of GDP – are the lowest of any major economy in the world.

An obvious counterpoint here is that inequality is always inevitable once development takes off in a backward, agrarian society. However, this is rebuffed by the fact that the Gini coefficients of South Korea and Taiwan from the 1960s to the 1990s, as well as China from 1978-1988 hovered around 0.29-0.34 even as the economies of these countries were growing rapidly.^{xiv} Significantly, the CCP has deliberately used vast resources to sponsor, co-opt, and in many respects create the privileged middle classes. The great lesson of the 1989 Tiananmen protests for the CCP was that the Party was better off tying the futures of the middle classes to the future of the CCP, than it was isolating them. It is from the urban middle classes, after all, that any impetus for political reform is likely to come. The heavy capital investment bias is slanted toward urban China. Enormous national resources are directed toward nurturing the middle class in China's cities and these middle

classes have been the great beneficiaries of China's state-led development model. This is reflected in the composition of the roughly 70 million CCP members. A third of these are businesspeople and entrepreneurs, a third are college students, and a quarter of these are professionals. Meanwhile, a massive underclass of up to a billion people is the downside of this strategy. It is not surprising that while middle class support for the CCP and the state-led model remains robust (while economic growth is strong anyhow) numerous internal Party studies show that support for the CCP in the poorer rural areas, in particular, is extremely poor.

A second problem is the lack of robust institutions needed by economies and societies that both develop and protect the fruits of it. The political imperative of retaining power severely impedes the building of the soft institutions needed for successful economies: enforceable property rights, independent courts and rule of law, independent financial and administrative organs, and independence and diversity amongst its intellectuals. For example, while judges are appointed by the CCP, Party officials are explicitly given the right to veto court decisions at all levels of the Chinese judicial system. Chinese intellectuals, the majority existing under state-funded institutions such as the Chinese Academy of Social Sciences, are severely constrained. The Property Rights Index released by the Heritage Foundation gives China a dismal score of 20 (which is the same rank as countries such as Bangladesh, Cambodia and Uzbekistan,) while South Korea and Taiwan rate reasonably well at 70.^{xv} All land is still owned by the state although individuals may own and transfer long-term leases. But as the report observes, China's judicial system is weak and even when courts try to enforce decisions regarding land rights, local officials ignore them with impunity. Over the past decade alone, an estimated 40-100 million households have had their land illegally seized or been offered inadequate compensation by local officials (usually in collusion with land developers.)

Third, the massive misallocation of the country's wealth combined with the entrenched corruption of officials is having 'real' economic and social effects. For example, independent studies suggest that unemployment and severe underemployment is around 10-20 percent in urban areas and 20-40 percent in rural areas.

Furthermore, reported significant instances of 'mass' social unrest (defined as involving 15 or more people) against the government have grown from a few thousand in the early 1990s to 90,000 instances in 2006 according to official figures. Ominously, Beijing has since stopped revealing these figures annually, rumored to be around 124,000 instances in 2008. Indeed, Beijing spends more on

internal security (the People's Armed Police) than they do on the People's Liberation Army. The vast majority of these protests are directed toward local officials for grievances against such things as illegal land seizures and taxes, mismanagement of the local environment either because of incompetence or collusion with well-connected industries, and the misappropriation of public funds for personal use.

It is true that China has come a long way since Mao died in 1976. But the reform period since Deng Xiaoping took power has surpassed the completion of its thirtieth year – exactly half the age of modern China. The reform period has exceeded Mao Zedong's 27 years of terrible rule. After ordering the crackdown on protesters in 1989, Deng presciently warned that the CCP had around 20 years to 'get China right'. The Party has not found the authoritarian version of the 'silver bullet' – where enhancing the CCP's relevance and grip on economic, social and ultimately political power is also a viable pathway leading toward Chinese modernity, progress and development. Instead, there is a direct and deepening connection between the CCP entrenching its place in Chinese economic and civil society, and China's growing economic and social deficits.

While it is true that reforms in 1979 have irreversibly unleashed the forces of modernity and progress within the country, they are being severely constrained even as the economy grows. Technical expertise and improving scale is one thing – something a small number of China's best central SOEs do well in. But with a model still reliant on replicating foreign innovation, enterprise and entrepreneurship, it is increasingly doubtful that a successful Chinese path towards modernity can be an authoritarian way.

India's democratic model – still muddling through?

What about democratic India's prospect of 'muddling through' toward the development of *a productive, stable, resilient and adaptive 'spontaneous model'*?

The impetus to reform in India was not as powerful as the one felt in Beijing in 1979 for one important reason: Democratic India never suffered anything like the horror of the Mao Zedong years. There was subsequently no systemic crisis of legitimacy comparable to the one faced by the CCP in the 1970s.

In comparison, although small steps towards reform were taking place in the 1980s, most commentators point to 1991 as the watershed year when the Soviet Union collapsed: India lost its primary trading partner and export market, and suffered a balance of payments crisis that forced the government to reevaluate its

protective and autarchic mindset. Even so, even the most optimistic India-watchers would describe the country's reforms as gradual and piecemeal.

Many of the modern reforms are targeted at the corporate sector: ease of setting up corporations, less red tape and regulation (especially abolishing licensing requirements), less restrictions to accessing capital, the gradual introduction of more flexible labor laws, trade liberalization, lowering of income and indirect taxes, opening up sectors to the private sector etc. This has unleashed the talent of India's entrepreneurs with the emergence of world class firms such as Infosys and Dr. Reddy's Labs – something which is rarely said about China's most successful firms that exist in virtual monopoly environments. Revealing, its strengths in IT, pharmaceuticals, biotechnology and services are sectors that do not need advanced infrastructure to succeed – something India is notoriously lacking in.

Anecdotal evidence, statistical data, and time spent in Mumbai's business hubs suggest that India's domestic private corporate enterprise in industry and services is more robust and autonomous than China's – reflecting the greater openness, uninhibited exchange and pluralism in the Indian model. But even if India's vibrant democracy and open society is proving much more conducive to productive evolutionary processes than is occurring in China, the Indian renaissance is genuinely vibrant but still restricted. The corporate sector covers only 6% of India's labor force, and the famed IT sector less than 0.5%. Despite the rise of genuinely impressive domestic corporate giants, some 87 percent of Indian manufacturing firms are still 'cottage' industries employing ten people or less. India is still feeling its way in a gradual, stop-start process of reform and enormous problems persist.

For example, there are problems with 'human capacity'. Unlike China, it did not invest in education to the same extent and illiteracy at around 25 percent remains well below global standards. The situation is particularly bad in rural India where around 50 percent of children never make it to secondary school – casting doubt that India can reap its demographic dividend in a country where half the population is still under 25 years of age.

There are also problems with the ‘national capacity’ to implement New Delhi’s policies for a number of reasons. Unlike China, India never went through a period of decentralization, meaning that a long chain-of-command exists for many decisions taken to be implemented. Moreover, whereas local officials and bureaucrats in China are given incentives to promote economic growth (although the lack of transparency and institutional accountability has led to enormous waste and corruption,) Indian officials and bureaucrats see their role as regulatory gatekeepers rather than economic facilitators – made worse by a still lingering socialist legacy and culture – something at odds with its business-minded middle classes. Despite the enterprise that undoubtedly exists, this has a constraining impact on economic activity – ranging from setting up a manufacturing plant to infrastructural funding and approvals that pass over different districts and administrative zones, to rigid application of bank lending rules.

India’s infrastructural limitations are particularly striking – particularly in roads and power generation and distribution - and the most frequent point of unfavorable contrast with China. The state-sector in both countries currently dominates infrastructural investment. Despite severe waste, China’s model of state-led fixed investment means that the country spends around 13-14 percent of GDP on infrastructure, compared to 5 percent in India. Because the Indian model, although more accountable, does not offer New Delhi the same access to the country’s capital that is enjoyed by Beijing, India has been attempting to encourage private industry to invest in infrastructure – with the results still too early to assess. Unlike in China, Indian state-owned investment entities remain encumbered by onerous public service and employer obligations that have been left substantially untouched.

Finally, unlike China in the 1980s, India has yet to embark on significant land reform – particularly in rural areas where titles are often non-existent, ownership is disputed, and borders are hazy. This has prevented poorer farmers and peasants from utilizing the land that they ostensibly own (e.g., building on it, borrowing against it, or selling it for a fair price) and pulling themselves out of poverty or subsistence living – hence India has not had the benefit of a Chinese style 1980s rural revolution.

Friedman and India's democratic potential

The section on India, compared to China, has been brief for one main reason: despite almost two decades since its 1991 crisis, reform has still been gradual, piecemeal and indecisive. While the shape and direction of the Chinese political-economy and model is relatively entrenched, India's is not. While we can speak informatively about the broad characteristics of a Chinese model, we cannot do the same for India.

There is no doubt that the Chinese economy is currently a much more formidable one than the Indian economy – although it is important to bear in mind that China began its reforms more than ten years earlier. Even so, it is possible to discern a trend in the respective approaches that could offer India an advantage in the pursuit of modernity.

Both countries suffered in the pre-reform periods because they pursued bureaucratic, Leninist command economies. It is important to note that Nehru was almost as suspicious of the private sector and dismissive of free markets as Mao. Each country suffered from too much state intervention rather than too little. Both treated the state as the only acceptable and plausible driver of economic growth, ingenuity and dynamism. While China had Leninist discipline in the 1950s and 1960s with disastrous and tragic results, India had the inertia, inactivity and stagnation of democratic socialism. It is still early days but while 'democratic India' is permanently entrenched, 'socialist India' remains less so.

This is a critical factor in both countries' attempts to strive toward their own modernity. Beijing is attempting to reinvent in its Leninist institutions to drive innovation, creativity, unconventional thinking and dynamism – something traditionally done by the private sector in freer societies – or else pour money into these Mao-era institutions and entities and treat superior technical capacity as a substitute for creativity and progress. In contrast, although still short of a comprehensive reform agenda, New Delhi is seeking to preserve its existing liberal-democratic institutions – which have proved enduring - and gradually leave behind its socialist past. In other words, although both retain a hybrid system,

China still sees a state-led, albeit decentralized, command model as its preferred path while India is looking to free up the constraints on its independent domestic private sector. In other words, China's ideal-type remains a top-down planned order, while India's is a bottom-up spontaneous order. China seeks to preserve and protect its Leninist institutions while India seeks to reform these.

There is a final element that goes to the heart of modernity in the context of comparing China and India. It goes back to the relationship between the rulers and the ruled; between the government and sources of political, economic, ideational and social competition that might challenge the government's power and influence. Modernity in any form – which implies evolution, transformation and progress – requires pluralism. The Indian model – including the government and the country's institutions – can easily accommodate pluralism and even thrive on it. The Chinese model attempts to suppress it, or at best regulate it. Authoritarian intolerance might often fast-track the transition from undeveloped to developing country; but reaches its limitations when striving for modernity. It is telling that while genuine reform has undermined the political system and existing institutions in China, such reform has served to strengthen these in India.

India has only just begun its contemporary reform journey whereas China is possibly reaching its end. Perhaps Friedman will be proved correct again.

ⁱ Fredrick Hayek, "The Use of Knowledge in Society", *American Economic Review* (XXXV, No. 4, September 1945), 519-30.

ⁱⁱ The period from June 1989 when the Tiananmen protests occurred to 1991 is commonly referred to as the chaotic 'Tiananmen Interlude' period.

ⁱⁱⁱ Kate Zhou, *How the Farmers Changed China* (CO: Westview Press, 1996).

^{iv} Quoted in Will Hutton, *The Writing on the Wall* (London: Free Press, 2007), 99.

^v See John Lee, *Will China Fail?* 2nd edition (Sydney: CIS, 2009.)

^{vi} See Usha Haley, *Statement before the US-China Economic & Security Review* (Washington DC, April 4, 2006.)

^{vii} See Nicholas Lardy, "China's Worsening Debts", *The Financial Times*, 22 June 2001, p 13.

^{viii} "China 2007 investment may rise 25%", *China Daily*, April 29, 2007.

^{ix} A coefficient of 0 means perfect income inequality and a coefficient of 1 means perfect income inequality.

^x Jiandong Chen, Wenxuan Hou and Shenwu Jin, "A Review of the Chinese Gini coefficient from 1978-2005," *Social Science Research Network Working Paper Series*, 16 January 2008.

^{xi} "China suffers widening income gap," *China Daily*, 1 July 2007.

^{xii} See Statement by Dr. Joshua Muldavin, *Major Internal Challenges Facing the Chinese Leadership*, U.S.-China Economic and Security Review Commission, 2-3 February, 2006.

^{xiii} Richard McGregor, "China's Poorest Worse Off after Boom," *Financial Times*, 27 August 2006.

^{xiv} Kui-Wai Li, *Capitalist Development and Economism in East Asia* (London: Routledge 2002), p 55.

^{xv} <http://www.heritage.org/index/Country/China>