Reform Strategies of China and India: Suggestions for Future Actions

Abstract

This paper compares economic reforms in the two most populous economies of the world: China and India. While both China and India opted for a gradual approach to reforms, India had to begin with stabilization measures due to the fiscal and balance of payments crisis of 1991. Since Chinese reforms were initiated long before India’s, the latter country could benefit by drawing relevant lessons from the former. Reforms are far from complete in either of the countries. In the case of China, further reforms need to concentrate on different issues such as social welfare, insurance, housing, state-owned enterprises, and the financial system. In India, continued reform actions are required in the areas of fiscal consolidation, openness of the economy, tax reforms, foreign investment policy, and the financial sector. In addition, reforms need to be initiated in areas such as exit policy, labor and land laws, decentralization of decision making power, and opening up of the insurance sector. The high growth experienced by the non-state sector in China could well be achieved by the private sector in India if it were to be extensively deregulated.

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I. Introduction

China’s high economic growth since 1978 has been a hot topic of discussion in economic development and economic reform literature for the last few years. Her 10 percent annual average growth rate plus her largest population has made China the largest and the most attractive market in the world for business and investment for several years. India, the second largest country in terms of population, initiated her reforms in 1991 and has achieved some satisfactory results so far. If India can replicate China in terms of economic growth and development, not only will Indians benefit from the rise in living standards, but also, like China, India will become a sought after market that will provide numerous business and investment opportunities. The boom will mostly have a positive effect on other countries.

The Chinese and Indian economies put together make up two-fifths of the human race. These continental size nations have a lot in common and hence a comparative study of their reform strategies can be helpful for both to learn from each other’s experiences. While China has been the focus of world attention for some time now, India has only recently begun to be noticed. Of course, this is largely because China has had a thirteen-year head start over India in consolidating economic gains after launching her program of economic reforms in 1978.

Beginning in 1950 in China and 1947 in India, new governments took charge in both the countries, led by Mao Zedong in China, and Jawaharlal Nehru in India. While China was to be governed under a communist dictatorial regime, India, on the other hand, was to be a parliamentary democracy, with a socialistic pattern of society. Both Mao and Nehru were freedom fighters and men who enjoyed vast domestic support and international appreciation. Governments of both men chalked out major action plans to accelerate the process of economic development. While in China development policies, plans, and programs laid emphasis on centralized governmental controls of a Soviet-type system, in India a national planning commission was established to formulate comprehensive five-year plans, but centralized planning in India was not equated with the suppression of private enterprise.

China’s pre-reform economic system was basically a direct copy of the Soviet model, though with some modifications. After the three-year recovery period (ended in 1952), China began her first five year plan of economic construction 1953-57. With the help of Soviet experts, the economy was designed as highly centralized and heavily tilted towards the heavy industry as against light industry and agriculture. In October 1957, Chinese authorities began to realize certain drawbacks of such a totalitarian system and hence extended more decision making powers to local governments and enterprises, and introduced some incentive schemes. However, in 1958, Mao Zedong, obsessed with the success of development till then, initiated the Great Leap Forward to hasten the process of development. The Great Leap Forward (1958-60), the natural disaster (1959-61), Soviet withdrawal (1962) and the Cultural Revolution (1966-76) heavily influenced the course and speed of Chinese economic development. However, in any case the economy was heavily dominated by the concept
of socialist public ownership, which was established in the 1950s through nationalization of industrial and commercial enterprises and collectivization of rural land. China was able to maintain a relatively high growth rate\(^1\) prior to the economic reforms by heavy governmental investment at the expense of suppressed consumption. From the above one would note that the Chinese economic development was heavily influenced by the political set up which was in place.

In India, while there was a large and growing public sector, the country’s basic approach to economic organization was that of a mixed economy. The state owned and managed several key industries including steel, coal, and fertilizers, and banking and insurance in the service sector, but in several other sectors, state enterprises co-existed with privately-owned enterprises. Besides, a large chunk of economic activity, including agriculture, was an area where the state had no presence. Over the years, however, the state increasingly regulated the activities of the private sector through an extensive system of controls, including licensing and price controls. These controls and regulations exacted a heavy price, and the economy was caught in a low level equilibrium trap\(^2\).

Perhaps, during the early 1950s, Nehru’s idea of a mixed economy emerged due to pragmatic and political considerations of that time. Also, mixed economy at that time was a novelty and imbibed in itself ideas from both the capitalist and the socialist systems. In a way it was following a middle Path. Nehru’s speech to the Parliament in 1956 sums up the pragmatic considerations of the mixed economy concept: “I can understand ‘prevent that, control that, plan for that’; but where there is such a vast field to cover, it is foolish to take charge of the whole field when you are totally incapable of using the whole area yourself. Therefore, you must not only permit the private sector, but, I say, encourage it in its own field.”\(^3\) Briefly put, both China and India followed the same development strategy, that is, the strategy of state-led industrialization.

This paper is organized as follows: in the next section we compare the initial conditions and reform strategies of the two countries and then we suggest what further reforms are required in China to sustain her high growth, and what India’s future reform agenda may be to attain and sustain growth rates comparable to those of China.

II. Initial Conditions and Reform Strategies: China and India

The Chinese and Indian programs of economic reform were initiated for differing reasons. While the Indian reforms were undoubtedly crisis driven, the Chinese reforms began for a variety of reasons. The Cultural Revolution (1966-76) was perhaps the most significant one. Besides, there was a strong faction in the Chinese communist party which believed in reforms, and with Deng Xiaoping coming to power in 1978, this faction became powerful. Deng had realized that if China was

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1 Though GDP growth rates are not available, because China does not have GDP data prior to 1978. However, we may use national income growth rates to approximate. The annual constant price compounded growth rate was above 5.99% between 1952-1978, according to our calculation using CSSB 1995’s data.

2 During the period 1950-80, India’s average annual GDP growth is placed at 3.5%.

to catch-up with the advanced countries, there was no way but to go for market-oriented reforms. Secondly, while there was no economic crisis in 1978, imbalances were developing and income inequalities widening and it was perhaps a foresight on the part of the Chinese leadership to recognize the fact that reforms were indispensable if China was to avoid getting into a serious economic crisis.

a) China

Unlike most other countries where reforms were usually driven by crisis, Chinese reforms were initiated without an intervening economic crisis. Apart from the negative impact of the Cultural Revolution, another important driving force for Chinese reforms was the ideological change in the country from the top to the bottom. After the Cultural Revolution in 1976, the whole country felt great relief from the long political struggle. But, the entire country, from the party members to the masses, were completely at a loss. They did not know what to do and what to believe in! Many of the top party leaders, represented by Deng Xiaoping, who suffered during the Cultural Revolution, also doubted if planned economy was the only form of a socialist economy, and strongly opted for reforms. Secondly, Chinese leaders realized that the economy had already been distorted a great deal by 1978, and that it was tilted too much towards heavy industry. Thirdly, large imports were required for huge projects initiated between 1976-1978, creating pressure on the balance of payments, thereby requiring foreign trade reforms.

Since China was not facing serious economic crisis at the time of initiating her reforms, there was no need for stabilization measures and there were no external pressures on targets to be met within a specified time table. These were unique characteristics that China had, and to a certain extent, they helped China succeed in her reforms.

China began her reforms with a low inflation rate of 0.7 percent since prices were controlled by the state. The urban unemployment rate at that time was 5.3 percent, the highest since 1957. The relatively high unemployment was due to two factors: urban recruitment in enterprises and government was low or negligible during the Cultural Revolution, and educated youth who were sent to the country-side came back to the cities, but were unemployed. Large numbers of unemployed youth were a potential source of instability.

It was under such a social environment that China initiated her reforms. The reforms carried out thus far may be characterized as experimental, gradual, and priority related. Due to the lack of political consensus in the party leadership, reforms by implication, were experimental and gradual in nature. Stability has always been emphasized throughout the reforms. Urban unemployment problem along with short supply of consumer goods were addressed immediately by the reforms by encouraging light industry and the service sector. Later on, the small town promotion policies (in the early 1980s) and high economic growth allowed China to maintain low unemployment. While stability has been the key for the success of the reforms, at different points of time, priority has been given to specific areas. The early establishment of the Committee of Economic Reconstruction (a ministry under the State Council) to design and coordinate the reforms has also contributed a great deal towards the success of the reforms.

The reforms started in the least resistant areas (rural areas and collective ownership) to relatively more resistant areas (urban areas and the SOEs). Such a reform sequence is seen to be of
critical importance for success. As in conducting research, the reforms in China have been a learning-by-doing process. The initial success educated, prepared, and convinced the people as well as the leaders for further reforms. For the toughest and sensitive areas (the SOEs and financial sector), China has been very careful, and has broken up tough problems into smaller ones. In the case of reforming the SOEs, instead of privatizing them outrightly China went through their reform in several steps. Among them, were introducing the job responsibility system, switching profit-remit tance system into value-added-taxation system, replacing fiscal grants with bank loans, allowing joint ventures with private or foreign investment, separating their administrative functions from management activities, allowing them to issue stocks, mergers and acquisitions, bankruptcy, etc. Solving the toughest issue through several easy steps effectively minimized the adjustment costs, maintaining low unemployment rate, and thereby keeping the social and economic stability under control. All these measures contributed towards the smoothness of reforms.

To change from a planned economy into a market economy, the most important thing for China was to create a competitive environment for business. Macro economic policies were modified to fit such changes at the micro level. Macro reforms were carried out along side three lines: 1) To introduce competition and market-oriented policies by changing from direct control into indirect control, physical indicators replacement by monetary indicators, and using reform measures to adjust economic activities rather than through the plan; 2) To optimize the economic structure and balance the interests of individuals, enterprises and the government; 3) To maintain social and economic stability: low unemployment and inflation.

In the area of production policies, China began to switch from the order of heavy, light and agriculture industries to agriculture, light, and heavy industries. Prices of agricultural products were raised a number of times beginning in 1979 to stimulate agricultural production. The policy of self-reliance in grain production was replaced with a policy that encouraged various economic activities in rural areas such that production choices revealed regional resource advantages and personal skills. In the industrial sector, investments were encouraged in light industries vs heavy industries. Industrial firm policy changed from emphasizing “completeness” or “comprehensiveness” towards “specialization.” Military industries were switched to produce consumer goods.

Open door is one of the most important aspects in China’s macro economic reforms. To ensure the success of open door policies, Chinese authorities promulgated rules and regulations for foreign investment with favorable terms and conditions. Laws were made keeping in mind the international standards. Land has been leased typically for more than 15 years and could be as long as 75 years, implying thereby that open door policies were now going to be the country’s long term economic policies. Foreign trade was decentralized, provinces and localities were allowed to have their own trade corporations. Some big enterprises were also allowed to engage in direct foreign trade. As a result, Chinese trade volume doubled every five years since the reform. Openness as measured by total foreign trade as percent of GDP increased from 9.9 percent in 1978 to about 33 percent in 1993. Joint ventures accounted for about one third of China’s exports. Annual foreign

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4 For discussions on reforms of foreign trade, foreign exchanges, foreign investment, please refer Section Two, subsection 5) on open door policies.
direct investment increased basically from zero prior to the reforms to $27.5 billion in 1993\textsuperscript{5}. By September 1995, cumulative foreign investment in China was around $110 billion. China became the second largest foreign investment absorbing country in the world, next to the USA, and in 1995, over 100,000 joint ventures were operational in China\textsuperscript{6}.

From a highly centralized fiscal setup, which fitted the planned economy, the system was transformed such that the central, provincial and local governments have their share of revenues and expenditures. Before 1978, all the tax revenues and profit remittances were deposited with the central government which, in turn, allocated the resources according to the state plan. Since the reforms, the pie has been divided from the source according to certain formulae\textsuperscript{7}, though seemingly the revenue share for the central government went down considerably, to a large extent, the central government’s fiscal responsibilities were shifted to provincial governments. That is why China’s fiscal budget deficit has stayed around 2 percent of her GDP since the reform even though central government’s revenue has gone down considerably relative to GDP. Also local fiscal revenues and expenditures are linked together so that each jurisdiction has more incentives to control their revenues and expenditures. Yet another major shift in fiscal policy has been that from very beginning of the reforms, the firms and workers have been given higher shares in the profits than before. Such a shift stimulated the incentives, and thus resulted in higher production.

As for tax reforms, the most important step, perhaps, was the transition from the SOE profit remittance system to value-added tax system. Also, the one form tax (consolidated industrial and commercial tax rate) has been diversified into many classifications, including business tax, consumption tax, corporate income tax, individual income tax, etc. In 1994, China adopted a unified tax rate for domestic enterprises of 33 percent to create competition on an equal footing. For joint ventures, corporate income tax rate was also fixed at 33 percent. However, joint ventures enjoy preferential income tax rate at only 15 percent in special economic zones (SEZs) and 24 percent in coastal open cities. Between 1978 and 1993, the fiscal revenue increased at an annual average rate of 23.5 percent. In 1995, during the first ten months it increased by 24.3 percent\textsuperscript{8}.

Financial sector reforms have come a long way with China’s economic development. Before 1978, banking played very limited role in the Chinese economy. In 1978 The People’s Bank of China (PBOC) was the only bank in China. PBOC was an issue bank as well as a commercial bank. As rural reforms progressed, Agriculture Bank of China was re-established in February 1979 to take care of rural deposits, and grants and credits to rural areas\textsuperscript{9}. In April 1979, Bank of China was made

\textsuperscript{5} CSSB, 1994.


\textsuperscript{7} The portions given to provinces variate among provinces depending on economic development stages. The ways of calculating such portions also have changed over time as fiscal reform proceeded. For a comprehensive description, refer Gao, Wang & He, 1994 and Zhongguo Gaige Quansu, 1992.


\textsuperscript{9} Agriculture Bank of China was established in March 1955. Like several other financial institutions, Agriculture Bank of China was abolished, and then resumed after the reforms.
independent from the PBOC to specialize in foreign exchange transactions. In September 1983, the State Council decided to separate the commercial business from PBOC, thereby establishing the Industrial and Commercial Bank of China. Meanwhile The People’s Construction Bank of China was also separated from the Ministry of Finance to deal with long term policy capital loans.

By mid 1980s, China had established several specialized national banks, a national investment corporation, insurance companies, and provincial investment and trust corporations, but all of them were state owned, and their business was heavily influenced by state or local governments. Since 1987, China has allowed several banks to be established by issuing shares. Subsequently, private banks were also established. In 1994, China established three policy banks to separate policy loans from commercial loans and let commercial banks be more independent. In 1995, commercial banking law and central banking law were published.

Chinese financial market reforms began with issuance of treasury bonds in 1980\textsuperscript{10}. In 1982, China International Investment and Trust Company (CITIC) issued Chinese bonds in Japan. This was the first Chinese bond issued abroad since 1949. Since then, many other financial corporations issued bonds in Japan, Hong Kong, Singapore, Europe and the United States. In 1985, Chinese financial banks began issuing financial bonds in the domestic market. Corporate bonds and stocks were first issued around 1984, though many of the initial stocks were actually termed bonds. By 1991, there were more than three thousand enterprises that had issued stocks, 90 percent issued stocks to internal employees, and 300 issued among enterprises. 80 enterprises openly sold to the public\textsuperscript{11}. Since 1990, two stock exchanges (in Shanghai and Shenzhen) have been established, which now list shares of more than 200 Chinese companies, and some of them also issue shares denominated in hard currencies. A number of Chinese companies have also entered the Hong Kong and New York stock exchanges.

b) India

Statistics bear testimony to the fact that the genesis of the economic crisis in India, which surfaced in 1991, lies in the large and persistent macroeconomic imbalances that developed over the 1980s. A detailed examination of the government expenditures, over the 1980s, suggests that the root cause of the crisis was the large and growing fiscal imbalances (Bajpai, 1995). Large fiscal deficits emerged as a result of mounting government expenditures, particularly during the second half of the 1980s. The government had to take recourse to large borrowings from the Reserve Bank of India which had an expansionary impact on the money supply leading directly to high rates of inflation. Also, because of the dynamic inter-relationship between the fiscal and the trade deficits, the former resulted in large current account deficits in the balance of payments. Besides, in order to meet these deficits, large external commercial borrowings were undertaken, which, in turn, aggravated the problem of external indebtedness.

The gross fiscal deficit of the central government rose from 5.7 percent of GDP in 1980-81 to 8.3 percent in 1990-91. Since a large part of these deficits was met by borrowings, the internal debt

\textsuperscript{10} Treasury bonds were not transferable until 1988.

\textsuperscript{11} Gao, Wang& He, 1994, p 464.
of the government accumulated rapidly, rising from 35.6 percent of GDP at the end of fiscal year 1980-81 to 52.9 percent of GDP at the end of 1990-91. As a consequence, interest payments increased from 1.9 percent of GDP and 10 percent of total central government expenditure in 1980-81 to 4 percent of GDP and 20 percent of total central government expenditure in 1990-91.

An unprecedented balance of payments crisis emerged in early 1991. The current account deficit doubled from an annual average of $2.3 billion or 1.3 percent of GDP during the first half of the 1980s, to an annual average of $5.5 billion or 2.2 percent of GDP during the second half of the 1980s. Since large external borrowings were undertaken along with contraction of substantial short-term debt, the external debt rose from 12 percent of GDP at the end of 1980-81 to 41 percent of GDP at the end of 1990-91. As a result, the debt service burden rose from 10 percent of current account receipts and 15 percent of export earnings in 1980-81 to 35.5 percent of current account receipts and 30 percent of export earnings in 1990-91.

The balance of payments came under severe strain from one liquidity crisis experienced in mid-January 1991 to another in late June 1991. On both occasions, the foreign exchange reserves dropped significantly and the government had to resort to measures, such as using its stock of gold to obtain foreign exchange, utilization of the special facilities of the IMF, and also emergency bilateral assistance from Japan and Germany among others. Having resorted to these measures the government was able to avoid a default in terms of meeting its debt service obligations and financing of imports. Subsequently, the government embarked upon a comprehensive program of economic reforms. The program comprises policy measures for attaining macro stability and a shift to a higher growth path via structural reforms.

The authorities in India have followed a gradualist approach to economic reforms. Being crisis induced, the reforms in India have had to focus initially towards macroeconomic stabilization. Simultaneously, reform of the industrial policy, trade and exchange rate policies, foreign investment policy, were initiated along with tax reforms, financial sector reforms, and public sector reform.

In the area of industrial policy reform, the government abolished industrial licensing except for a select list of hazardous and environmentally sensitive industries; the limit on investments in large Indian/Foreign companies was scrapped; all industries were thrown open to the private sector, except for six strategic and defense related industries; and access to foreign technology was made much easier.

Reforms in the trade and exchange rate policies have inter-alia entailed abolition of import control through licensing except for consumer goods which remain restricted; import duties have been reduced in stages with the maximum duty lowered from 150 percent in July 1991 to 50 percent in February 1995; basic customs duty on project imports and general capital goods reduced to 25 percent; the rupee made convertible on the current account and its exchange rate is being determined by the demand and supply conditions in the foreign exchange markets.

With regard to foreign investment, the government announced a new policy, designed to attract foreign investment in larger volumes, by simplifying rules and procedures and making the terms offered to foreign investors more in line with current practice all over the world. Among other things, the new policy allowed automatic approval of 51 percent foreign investment equity
participation and foreign technology agreements in case of 34 high priority industries; investment above 51 percent equity was permitted on a case-by-case approval by the Foreign Investment Promotion Board (FIPB); relaxation of government control over disinvestment of foreign equity; and automatic approval of joint ventures abroad if the Indian contribution in cash is up to $500,000 and in kind up to $2 million.

Tax reforms in India have moved more or less in line with what the Tax Reforms Committee had recommended. While the reforms on this front have been slow, they are moving in the right direction. With regard to direct taxes, reforms are aimed at moderate tax rates, fewer deductions, removal of certain exemptions, broadening of tax base through presumptive taxation of small traders and reduction of corporate tax rates. Besides, steps have been taken for effective enforcement for encouraging voluntary tax compliance and raising revenue through simplified tax laws, rules, procedures, and forms. With regard to indirect taxes, major thrust has been to lower the level and simplify the structure of customs duties. In the area of excise taxation, however, the process of simplification was delayed and commenced in the 1993-94 Budget. The government proposes to move from the modified value added tax (MODVAT) in a gradual manner to a full VAT.

Financial sector reforms have covered banking, insurance, and capital market reforms. To improve the working of banks, a strong prudential regime regarding capital adequacy, income recognition, loan-loss provisions, and transparency of accounts have been established. Financially weak banks have been recapitalized. Profitable banks have been permitted to access the capital market to augment their capital. For the nationalized banks, this involves dilution of government equity in these institutions. To enhance competition, many new private sector banks, including some foreign banks, have been allowed entry into the market. In the insurance sector, the government is considering the report of the Committee on Reform of the Insurance Sector. An independent insurance regulatory authority has been setup perhaps as a first step towards introduction of competition in the insurance industry which is a government monopoly. With regard to capital market reforms, corporations are now free to issue capital and price their issues. Foreign Institutional Investors (FIIs), about 280 in number, have been permitted to invest in the Indian capital market and about 80 of them are quite active. Besides, Indian companies have been allowed to access foreign markets for raising equity and debt finance.

In the area of public sector reform, equity of selected units is being disinvested up to 49 percent with a view to mobilize non-inflationary resources for the budget and create a greater commercial orientation in the management of these units. Furthermore, budgetary support in the form of non-Plan loans to loss-making units is being phased out. In order that expansion of such units may be determined by their profitability, the government has permitted them to raise fresh equity from the market. The Sick Industrial Companies Act (SICA) has been amended so as to bring the public sector units within the jurisdiction of the Board for Industrial and Financial Reconstruction (BIFR) which will decide whether these units can be effectively restructured or whether they should close down.

The Indian reform strategy of stabilization-cum-structural reforms has produced satisfactory results so far. The annual rate of inflation has come down significantly. Wholesale price index which peaked at nearly 17 percent in August 1991 was brought down steadily to 5.7 percent in 1995. Similarly, the rise in the consumer price index which was 13.9 percent in March 1992 came down to 5 percent in December 1995 on a point to point basis.
GDP growth, which had dipped to 0.9 percent in 1991-92, recovered to 5.1 percent in 1992-93, and grew at a sustained level of 6.2 percent in both 1994-95 and 1995-96. Industrial growth, which had fallen to 0.6 percent in 1991-92 showed significant recovery and was 7.4 percent in 1994-95. Foreign currency reserves, which had fallen to just above $1 billion recovered swiftly to $6.5 billion in March 1993 and $20.8 billion in March 1995. The export-import ratio has averaged nearly 90 percent during 1991-94 compared to an average of about 65 percent for the preceding three years. Exports in the financial years 1993-94 and 1994-95 (between April and January) increased by 19.6 and 17.3 percent respectively. Non-oil imports in 1994-95 have also surged by 28 percent. However, the current account deficit remains at less than one percent of GDP. This has resulted partly because the deficit in the invisible account has been converted into a surplus as a market-determined exchange rate of the rupee has encouraged inward remittances through legal channels.

The sharp decline in the current account deficit and the large capital inflows are reflected in the build-up of the foreign currency reserves of the RBI. The composition of foreign capital inflows is fast changing towards equity as against debt. External assistance, external commercial borrowing, IMF loans, and NRI deposits declined progressively from 85.5 percent of net capital inflows in 1990-91 to 40 percent in 1993-94. Inflows of foreign investment in the form of global depositary receipts (GDR), foreign institutional investment (FII), off-shore funds, and foreign direct investment (FDI) have witnessed sharp increases. The total FDI approved since 1991 till 1994 amounts to $7.2 billion, against just under $1 billion approved during the previous decade (1981-90). The actual FDI inflows quadrupled from $150 million in 1991-92 to $620 million in 1993-94. In 1994-95, the actual FDI inflows were around $1.3 billion.

c) Summary

To summarize, Chinese reforms took place in a gradual and sequential manner. The reforms in China were not crisis driven hence the authorities had much more freedom in the design and implementation of the reforms. Since the major problems of the pre-reform Chinese economy were lack of incentives and excessive control through the plan, reforms started with responsibility system and aimed at creating a competitive environment. The essence of responsibility system which succeeded first in rural areas has been adopted in almost every aspect of the Chinese economic system, even in the central-local fiscal relationship. Reforms in tax, price, distribution system, exchange control, foreign trade, and foreign investment have all been coordinated, and have contributed towards introducing competition and growing out of the plan. In the initial stage, while trying to create incentive schemes at the micro level, the reforms addressed the distorted economic structure by readjusting production sectors and balancing consumption vs. investment. The further deepening of reforms were solidly supported by the masses and driven, to a large extent, by the success of initial reforms.

As in China, economic reforms in India have also followed a gradualist approach, but have essentially been crisis driven. The year 1991-92 witnessed a stabilization induced recession, but growth soon picked up thereafter. The authorities in India recognized the fact that in order to achieve rapid growth, efficient use of resources was essential and competition, both domestic and foreign, was the best means of ensuring efficiency. Keeping these broad objectives in view, reforms have been undertaken in the areas of industry, trade and exchange rate, foreign investment, tax policy, and the financial sector. These reforms, slow moving as they are, are gradually leading the domestic industries to be in line with India’s factor endowments and to be globally competitive. Put simply, India’s
reform strategy has been to dismantle four decades of central economic control. Among other things, it included controlling fiscal deficit, cutting and rationalizing corporate and personal taxes, abolishing industrial licensing, encouraging foreign investment, liberalizing import rules and cutting duties, encouraging exports, and deregulating India’s archaic capital markets. A lot still remains on India’s unfinished reform agenda, and the success achieved so far should go a long way in speeding up the implementation of the remaining reforms.

III. Further Reforms to Attain and Sustain High Growth

China:

As we noted earlier, social and economic stability has been a major factor, among others, for the success of the Chinese reforms. To sustain high economic growth, therefore, it is crucial for China to maintain stability. However, signs of instability have shown up as reforms progressed despite the success. Among them are corruption, crime, unemployment, and income inequality. According to a survey\(^\text{12}\), China was ranked second most corrupt country among forty-one countries that were surveyed between 1992 and 1994. Corruption is not only in business related government administration, but also rampant in school enrollment. Corruption, if not checked, is certainly going to be harmful to growth. However, we believe it is a natural phenomenon in the development process of the LDCs, especially for economies that experience very high growth. As long as the government keeps it in check, and improves laws, removes the remaining controls, corruption will go down as the economy develops further.

In the past few years, China has observed a small rise in her urban unemployment. It is very likely that such a rise will continue in the next few years. The rise in urban unemployment has exerted pressures on cities, especially because of safety concerns. Therefore measures need to be taken to deal carefully with the unemployment problem. Two factors have caused the rise in unemployment: restructuring of industry sectors, especially the SOEs, and migration. People who got unemployed due to restructuring of their work units are most likely to be middle-aged. The only skills they have are related to their enterprises that have surplus laborers, or that produce goods not meeting the market demand. So without some retraining and help from job coordinating agency, their unemployment status is not likely to change for some time. Since the reforms, more than 80 million of rural residents are estimated to have moved to the urban cities allured by the higher paying jobs. However, such jobs, mainly unskilled work, are usually temporary, and vulnerable. In the event of retrenchment, the relatively less qualified migrants are the first ones to be axed. The fact that there exist more than a million surplus labor employed in the urban areas in 1995\(^\text{13}\) shows potential pressure on unemployment. This also calls for social security for the unemployment benefits.

Income inequality may also explain such rural-urban and west-east migration. As Jian Sachs & Warner (1995) shows China’s income disparity has significantly widened between the interior and the coast since 1990. To reduce such unbalanced development, policies on investment, taxation and

\(^\text{12}\) Results reported in the New York Times, August 20, 1995.

fiscal transfer need to be more accommodating. Recent decision of the Chinese government to eliminate some of the preferential treatment for foreign investors in the coastal region is a move in the right direction. Further opening up the interior to foreign investors will also contribute towards that goal. Promotion of economic collaboration between the interior and the coast will facilitate the flow of capital, technology, and information for mutual benefits. This most likely will benefit the poor regions more. On the other hand, regional protection for local enterprises will only be detrimental to their development. To reduce income inequalities, effective fiscal transfer is needed not only for economic development, but also for development of human capital. Funds for educating the poor western regions and rural areas are highly essential to ensure free primary education and to remove irritants in the process of higher school attendance. While education should be continuously stressed countrywide, college scholarships may need to be designated for poor and remote regions where many talented students are unable to pursue higher education due to financial hardships.

Inflation has been relatively high in China for the past five years, causing concerns on macroeconomic stability. While some causes of the rise in prices are natural in the reform process, such as reducing the control on food prices, other factors have also pushed up inflation. Capital inflows have increased tremendously since 1991. While high economic growth has absorbed much of the capital inflow pressure on inflation, care may be required to prevent excessive external borrowings. In some regions, rewards are related to the amount of capital one has been able to borrow. As a result, loans may have been acquired, but the project may be far from the implementation stage. This leads to excessive money supply and thus higher inflation. Another systematic error that causes higher inflation is the tendency of over investment by local governments. In China, promotion of local government officials depends on, among other things, economic achievements in the region. Local officials try to promote growth and employment through high investment. Excessive demand for capital goods as a result of high investment pushes up national price level.

Recent tax reforms on tax collection and to unify tax rates for enterprises of different ownerships have improved the tax system and increased tax revenues. However, further reforms are still needed to improve the tax collection procedures. As noted by Mr. Xiang Huaicheng, Deputy Head of the General Tax Bureau in December 1995 (the People’s Daily), although tax revenue for the country went up by 28 percent in 1995 over the preceding year, large sums of taxes still remain to be collected. Another problem is that a much larger proportion of such uncollected taxes is supposed to be paid to the central government. The second problem may show that either local governments have strived to collect their portion or enterprises have tried to please local government officials while ignoring their obligation to the central government. The worse scenario could be some collaboration between enterprises and local governments for their tax agreements. To increase tax collection, the new tax system and regulations must be widely publicized. Lack of tax education and previous practices of tax reporting, especially for the small enterprises and individuals, could be an important factor leading to low rate of tax reporting. Meanwhile, tax reporting regulations may need to be modified, and local and central governments should coordinate their tax collection procedures.


15 Though not proved, there have been reports of such practices.
For instance, on the one hand, there should be some penalty on not reporting total income or delay in tax payments. On the other hand, more tax officials may be needed to help and teach individuals or enterprises how to file tax returns. Some training on new tax procedures may be worthwhile for enterprise accountants. Mechanism of coordination between local and central governments should be established to ensure that each entity pays both local and central taxes, otherwise some penalty should be automatically imposed.

As discussed in section II, reforms of the SOEs have undergone many steps and many objectives have been achieved. However, much remains to be done. It is, perhaps, one of the most complicated issues in the reform process. Unlike in the western countries, China’s SOEs act not only as an economic entity, but also as a “big family”. In a sense, the SOEs not only produce and/or trade, but they have numerous social obligations towards their employees. However, such obligations have some what been reduced over the years. While SOEs vary a great deal, especially between the small ones and the large and middle sized ones, in general, SOEs provide housing, child care, and health care. For large and middle sized enterprises, some of them run schools and hospitals, and some even act just like a city with government administrative functions. While, on the one hand, the SOEs have a lot of functions other than enterprise related, on the other, for many SOEs, the ownership of their property assets have seldom been designated to any particular government institutions. For such enterprises, before any privatization is being implemented, reforms should make sure that the SOEs really act as a real enterprise, and assets should be carefully checked, registered, and designated to some particular institution. This will not only prevent further losses of SOE assets, but also reduce exploitation of loopholes for corruption. Ownership transformation and organizational transformation (from SOEs to stock companies, for example) are much easier for the smaller ones than larger ones.

To ensure smoothness in SOE reform, reforms of the welfare system are important and urgent. Welfare reform has begun only in recent years. Welfare has basically been related to people’s workplace. Prior to the reforms, only in the extreme cases would one find employees being fired. To some extent, whatever happened to the employee, usually his/her work unit would take care of it. However, in recent years, jobs may not be life long, and for various reasons, people do loose their jobs. Without reforms of the welfare system, loosing a job would imply loosing everything: health insurance, pension, income, and housing (theoretically at least). So without reforming the welfare system, the negative impact of unemployment would be much more severe. Besides, in the absence of welfare reform, any real labor mobility would not be possible, mainly because of pension and housing concerns.

In China the amount of pension paid depends on the length of time that one has worked (it does not matter where one has worked), and depends on one’s income on retirement. Prior to the reforms, on the one hand, basically there was no labor mobility and the plan took care of the budget of SOEs, so each enterprise did not have to worry too much about pension payment. On the other, among other things, because of the pension, and especially housing considerations, labor mobility across work units was highly limited. Under such a welfare system, if one intended to move from a SOE to a private enterprise, he must be willing to sacrifice his pension and housing which accounts for a large part of his previous earnings that he has claim on. That is why most of those who voluntarily left their SOE jobs to work in private enterprises or joint ventures are young or retired, unless housing is provided or earnings are sufficiently high. In other words, to a large extent, non-
transferability of pension plan and non-monetized housing benefits handicap the development of efficient labor market, and complicate the SOE reforms.

Housing reforms have been experimented in China for several years. Housing reforms have been undertaken in two ways: selling old houses to the occupying tenants and selling off newly built houses. Selling old houses at subsidized prices to their occupying tenants is equivalent to monetizing housing benefits, therefore such reforms have been mostly welcomed. However, selling of new housing has not been so successful. Though there has been a lot of residential construction and sales of such new buildings, not many houses have been sold to local residents. The reason is that newly built houses are generally beyond the reach of normal salary/wage earners. By the end of June 1995, there have been more than 40 million square meters of newly built houses unable to find buyers. Accordingly, some economists have suggested that prices should be lower to cut down surplus supply. We do not think this should be the solution, and may not even be the major reason though the prices may be a bit high. The price of the houses should be market determined.

Since there have been many sales (though most sold to foreign and domestic entrepreneurs), those houses sold may not have been much overvalued. On the other hand, Chinese reforms have yet to be completed, wages and salaries still do not reflect their real income for many reasons as some of them have been discussed above. Therefore, affordability of ordinary wage/salary earners should not be a criterion in judging the equilibrium of the housing market. Lowering the housing prices will only benefit the very rich and foreigners. So instead of simply lowering the prices, we think other measures should be taken to correct the market. For example, instead of providing housing directly, enterprises should monetize their housing benefits by increasing their wages and/or by providing financial assistance at the time when their employees buy new houses. To promote privatization of housing, the government should establish a housing program to provide low interest mortgage to citizens who buy houses for the first time. In the event of further purchases, however, the interest on mortgages should be in line with the market rate.

The present so called “managed floating” exchange rate system was established in January 1994 when the official exchange rates (5.80 Yuan/Dollar) merged with the swap rates (8.70 Yuan/Dollar) in the legal Foreign Exchange Adjustment Centers. The initial appreciation of the Yuan may be due to the fact that the swap rate in the secondary markets undervalued the local currency. So by merging the official rate with the swap rate the currency may have devalued more than required. There are reasons to believe that Yuan should have appreciated against the Dollar in the last couple of years, such as high economic growth, large capital inflows, and continuing current account surpluses. However, the extremely limited range within which Yuan/Dollar exchange rate fluctuated makes us puzzle that the intervention was, perhaps, too much. As a result, the rate has been basically fixed in 1995. Even in the event of the value of Dollar changing against other major currencies by more than a percentage point per day during 1995, Yuan/Dollar rate fluctuated only about 0.2 percent. Central bank intervention in the foreign exchange market may be necessary in China to stabilize the exchange rate in the transition process.

In general, reforms so far have been very successful and need to be carried out more or less in the same manner. Reforms should be implemented according to the government’s economic priorities. As we have discussed, since so many aspects of the economy are interwoven with each other, coordination is, and has proved to be, crucial for the success of the reforms. Open door policy
has provided China with additional growth impetus and facilitated the flow of information and technology. If the same idea is exercised for domestic linkages across provinces, we believe, it will further promote economic growth and, in addition it may reduce income inequality.

India:

Economic policy reforms have demonstrated very clearly in India that they can play a crucial role in stepping up India’s growth rate. The step-up in India’s growth rate in the last four years (1992-96) provides evidence to this effect. While the 1980s witnessed a rather limited deregulation and halting liberalization of only a few aspects of the then prevailing control regime, the reforms undertaken in the 1990s are much wider and deeper and would therefore contribute more meaningfully to higher productivity of the economy. A comprehensive implementation of reforms both at the central and the state levels will help create large scale employment opportunities and thereby reduce poverty. While a number of reforms have been undertaken during the period 1991-96, a lot still remains on the unfinished reform agenda. Moreover, the remaining reforms are within reach, and hence need to be implemented early. What does India need to do if it is to attain growth rates comparable to those of China? This is what we discuss next.

As we have discussed in section II, the Indian reforms were crisis driven. In order to attain a reasonable degree of macro stability, meaning an acceptable level of inflation and a balance of payments not in serious disequilibrium, greater emphasis needs to be given to the process of fiscal consolidation in India. The first two years of the reforms saw reduction in the fiscal deficit, from 8.3 percent of GDP in 1990-91 to 5.7 percent in 1992-93. However, the year 1993-94 saw a major slippage and the fiscal deficit bounced back to 7.5 percent. Considering the continuing inflationary strains, the as yet excessive pre-emption of the community’s savings by the government, the potential for crowding out the requirements of the enterprise sector, the pressure on interest rates, and the rising interest payments on government debt, it is extremely essential to reduce the fiscal deficit, mainly by lowering the revenue deficit. Besides, budgetary correction has hardly begun in the states whose combined fiscal deficit stands at around 3 percent of GDP.

The key area for action with regard to the process of fiscal consolidation is the reduction of the revenue deficit. Revenue deficit, revenue receipts minus revenue expenditures, as a percentage of GDP in 1993-94 (4.4 %) was in fact even higher than what it was in 1990-91(3.5 %). However, in 1994-95 it is 3.6 percent of GDP. The major constituents of the revenue expenditure are interest payments, grants to states, defense expenditure, and food, fertilizer, and export subsidies. In 1993-94, the interest payments exceeded net new borrowing implying that the government borrowed entirely just to pay back the interest. Interest payments alone, in 1994-95 are as much as 73 percent of the tax revenue of the central government and 5.4 percent of GDP.

To reduce interest burden in the future, the government can use the proceeds of disinvestment in the public sector enterprises (PSEs) to retire debt. Fiscal imbalances need to be corrected via exercising greater expenditure control and augmentation in revenues. Subsidies on fertilizers and food are important areas for expenditure control. In fact, the present system of subsidy distribution, that is through subsidizing fertilizer prices, has primarily benefited large land owners who have continuously benefited from the subsidies for decades. On the one hand, since there are no agriculture
income taxes, such subsidies are additional to the net profit of the large land owners. On the other, since subsidies were aimed at promoting agricultural production, perhaps, they have outlived their life. India’s food grain production reached a record level of 191.1 million tons in 1994-95. The public food stocks of food grains soared to a record level of 36 million tons in July, 1995. The expenditure on food subsidy can be reduced by limiting the sale of subsidized food grains to rural residents only, as against universal accessability of the present system. In addition, the fertilizer subsidy needs to be discontinued over the medium term. The government could compensate the small and marginal farmers for their loss of income by initiating a well targeted and time bound program for them. The other areas for expenditure control could be: limiting governmental employment, both at the central and state levels; reducing/eliminating subsidies to state electricity boards (SEBs) and irrigation departments in the different state governments. The subsidies for electricity and water could be completely eliminated if the SEBs and the irrigation departments were to align their tariffs in line with their cost structures.

While progress has been made in the area of tax reforms, the tax structure in India still remains very complicated with high rates of taxation with regard to both direct and indirect taxes. Import duties, for example, are still high and need to be brought down considerably. Tax revenues could be substantially raised if the tax reforms are speeded up and the tax administration is strengthened. State governments are required to start levying agricultural income tax, and the central government has to broaden its tax base and reduce the personal income and corporate tax rates further. The “zero-tax” companies need to be brought into the tax net by levying a minimum alternate tax on them which is based on gross corporate assets. Besides, the present system of domestic commodity taxation, both at the central and state government levels has to be transformed into a value added tax (VAT). In most of the countries, VAT has emerged as the major instrument of taxation since it is not only practicable, but also avoids cascading.

Besides, octroi levied by the different state governments needs to be eliminated since it obstructs free movement of goods within the country. In its place, as a source of revenue the state governments could perhaps temporarily share with the center a surcharge on petrol and diesel, for instance. Similarly, the cities that now rely on Octroi could switch to property taxes, as is done by most of the local governments the world over.

Economic reforms need to be pursued much more vigorously, both at the central and the state levels. In addition, the reforms need to be broadened in terms of their coverage so as to include areas hitherto not touched by the reform process. Sector specific policies need to be transparent and clear cut for speedy implementation of projects. More importantly, reforms need to move much faster than they have been doing so far.

Consumer goods import need to be liberalized. Since import of consumer goods are severely constrained both by QRs and high tariffs, the liberalization of these imports may involve elimination of QRs, and then reduction in these tariffs. On its part, the government envisages that all consumer goods would be on a tariff-cum-OGL\textsuperscript{16} import regime by 1996-97 except for some social, environmental, and health reasons.

\textsuperscript{16} OGL means Open General Licence. Items on the OGL list can be freely imported.
The Reserve Bank of India’s intervention in the foreign exchange market needs to be maintained so as to prevent the appreciation of the rupee which could result from capital inflows. Any appreciation of the rupee may be detrimental to India’s export efforts. On the other hand, the government should consider a gradual depreciation of the rupee, to compensate partly for price inflation. Under the present circumstances, perhaps a target of around 2-percent-per-year rupee depreciation may be suitable. In the process, the exporting community could look forward to a profitable environment for export expansion. While higher inflation may seem likely as a result of this policy (foreign exchange reserve build-up leading to higher money supply) it may not really be so if the economy is able to sustain a high rate of growth and if the budget deficit and domestic credit are kept under control.

Another significant area that needs attention is foreign investment. The current foreign investment policy of India is still restrictive. For instance, foreign ownership of between 51 and 100 percent of equity still requires a long procedure of governmental approval. In our view, there does not seem to be any justification for continuing with this rule. This rule should be scrapped, and made in line with the approval procedure that applies to below 51-percent foreign ownership investment. Industry specific incentives need to be offered to attract larger FDI flows. Expeditious translation of approved FDI into actual investment would require more transparent sectoral policies, and a drastic reduction in time-consuming red-tapism.

With regard to foreign investment, especially foreign institutional investment (FII), there is a view that the government should have a ceiling on them since these large foreign capital inflows have led to excessive money supply and consequently inflation. In our assessment, having a ceiling on foreign capital inflows may not be an optimal policy. In fact, the government can utilize these foreign capital inflows to speed up the reform process, particularly trade reforms and financial market liberalization.

Agriculture price reforms are urgent and the key to integration of about 700 million rural population into the mainstream of the reform. Agricultural price reform may be instrumental in India’s achieving high growth, just as it has been successfully done in China. For decades, India’s food grain prices have been administered by the state. This has resulted in not only fiscal burden, but also discouraged about 70 percent of her population from actively participating in economic activities in an optimal manner. The Chinese rural reforms were designed in a way that they provided the necessary incentives to the peasants, and consequently led to substantial increase in agricultural productivity. This provided farmers with additional savings and freedom in pursuing optimal economic activities. As a result, large number of Chinese TVEs came up and have contributed a great deal toward the dynamic growth in the Chinese non-state sector. We think India may be able to emulate this Chinese experience, given the appropriate agricultural reforms, including land reforms. The first step in this process will be to decontrol agricultural prices and to remove restrictions on agricultural land use. This would help provide the necessary incentives to the farming community. The growth in agricultural productivity will inevitably lead to the demand for more agricultural tools and machines. We think this process, as in China, will lead to the growth of rural small scale industries, some of which are already in existence.

As China’s experience demonstrates establishment of small townships to link the countryside with urban areas is a successful strategic policy for development. This will facilitate the
transportation between rural and urban areas. As for urban enterprises, this link opens up a bigger market and is easier for diversification or restructuring bounded by area limitations. Rural enterprises can compete also in the cities with their products using low labor cost. In this way, rural enterprises will help absorb surplus labor locally, thereby resulting in lesser rural-urban migration. Urban enterprises will also provide more employment opportunities since they would have a larger market. In addition, the linkage will benefit the rural industries via flow of technology and information.

Deregulation of the private sector is perhaps one of the most significant areas for the Indian reforms. Since almost 93 percent of the workforce is in the unorganized sector, it is of utmost importance to deregulate the private sector so as to get the unorganized sector workforce in the mainstream. Over the years, the government has been incurring large sums of expenditure in the interest of the organized sector employees. The unorganized sector workers are in the process forced to engage themselves in subsistence agriculture or low-productivity informal employment. We think deregulation in the private sector should be attached high priority, given its tremendous potential, while privatization may well be postponed for the time being. Indeed with a more open and deregulated economy, India may also be in a position to achieve high growth, based on labor-intensive manufacturing, that combines the vast supply of Indian skilled managerial and engineering labor, with foreign capital, technology, and markets.

The government needs to create a competitive environment for the private sector in India. Among other things, this would require labor law reform, which provides the firms with the necessary flexibility of hiring and dismissal of workers. An exit policy should be so designed that the firms can enter and exit from the market freely. While the reforms implemented so far have helped remove the entry barriers that were present for decades in the form of licensing, and exclusion of both domestic and foreign investors from a number of industries, the liberalization of the exit barriers is yet to take place. While it would be incorrect to ignore the need and potential merit of certain safeguards, it is also important to recognize that safeguards, if wrongly designed and/or poorly enforced would turn into barriers which may adversely affect the health of the firm. Exit policy needs to be designed in a way that it removes exit barriers and at the same time protects the necessary internal order of the firm.

If the private sector in India is to perform as China’s non-state sector, ready availability of land for setting up new business activities, and adequate infrastructure, including power, ports, roads, and telecommunications are equally necessary. Besides, since the land ceiling law, the Urban Land (Ceiling and Regulation) Act 1976, limits the growth of private enterprises, it requires urgent modification to accommodate industrial restructuring.

In addition to providing a conducive environment for the private sector, the public sector in India also requires to undergo reforms. The government monopolies in the insurance industry, and other infrastructure sectors needs to be abolished. Private sector participation, both domestic and foreign, in these key areas could play a very significant role in speeding up India’s growth process. Restructuring of ownership and management may be needed for loss-making state owned enterprises. According to the Committee on Industrial Sickness and Corporate Restructuring (CISCR), in 1989-90 there were 98 loss-making central government non-departmental companies which incurred a total (annual) loss of Rupees 195.9 million. On average, each loss-making company was incurring a loss of Rupees 2 million and this figure was rising over the previous years. Loss-making enterprises need to be liquidated. These companies are basically involved in the production of fertilizers, transport
equipment, consumer goods, agro-based products and textiles. In the service sector, they are in the field of transportation, tourism, and telecommunications.

There are a number of reasons why the process of restructuring and liquidation of sick firms is not only slow, but extremely difficult. Firstly, the approach adopted by the concerned regulatory agency, BIFR. At every level of mediation and decision-making, BIFR uses a consensus approach, implying thereby that all parties i.e., the management, workers, creditors, and shareholders must agree to a restructuring plan before any restructuring or liquidation can begin. Secondly, hostile trade unions with strong union practices (protected under the Trade Union Act, 1926) have systematically opposed restructuring in various degrees. Thirdly, state governments have followed very rigid practices, and finally the slow moving judicial process have all created strong barriers to restructuring and liquidation.

In our view, the government needs to give greater attention to, and provide larger resources for, primary education and primary health. One of the significant differences between China and India is in terms of the role played, and the significance attached by the two countries, in providing primary education and health to their teeming millions. While in the areas mentioned above, the government needs to withdraw itself, in the sphere of raising the literacy levels and providing greater access to basic health services, the government is required to play a much more enlarged role. Furthermore, if the full benefits of a market economy are to be reaped, an educated and healthy workforce is an essential requirement.

Primary education should, in fact, be made compulsory. Expenditure on women’s education is perhaps one of the most productive expenditure. It has shown to have helped bring down both fertility and infant mortality rates. The impact on the former is seen to be significant and similar in most Indian states. Besides, female literacy would also be instrumental in greater female labor force participation and raising the status of women in the society. Schemes, such as mid-day meals for school children can go a long way in not only attaining and maintaining high school attendance, but also improving child nutrition. Briefly put, a reorientation is required in the government’s social policy - high priority to human resource development.

In order to achieve growth rates comparable to China, India needs to launch a major effort to raise the rate of domestic savings much beyond the current level. This may be done especially by reducing government dissavings at the central and state levels through cuts in and refocusing of explicit and implicit subsidies, stricter control on the non-developmental expenditure, improvements in tax collections through stronger tax enforcement, and finally strengthening incentives for savings.

In conclusion we may say that the Indian reforms implemented so far have been successful, of course, their speed could have been faster. Fiscal consolidation is still something to be worried about, especially given that India’s overall government spending is still very high. In most of the sectors reforms are on-going, but in some they have yet to begin. These are, for instance, legal reform, including labor and land law; exit policy; decentralization of decision-making power; and the opening up of the insurance sector etc. Soft options have been selected on numerous occasions when it was time to take hard decisions.
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