CHAPTER 7

Governance and Economic Growth in China and India

Philip Keefer

One of the compelling lessons that China and India offer to other poor countries is the profound importance for economic growth and poverty reduction of allowing private firms to compete in markets from which they were previously barred and of providing the complementary governments services, such as infrastructure, that promote economic productivity. The governance environment of these two countries points to a second important lesson that has attracted less attention. Although the two countries have succeeded under highly disparate governance environments, and neither offers a high degree of security to entrepreneurial activity, the lesson is a positive one. The evidence presented in this chapter demonstrates that, based on the experience of China and India, poor countries should give a high priority to good governance.

Governance is a slippery concept. One common definition focuses on outcomes—the extent to which governments enact and implement policies in the interest of all citizens. Another focuses on political institutions and dynamics that determine these outcomes—the extent to which governments have incentives to adopt and enforce policies in the interests of all citizens. Corruption is the most frequently used indication of weak governance outcomes. The ineffective translation of public resources into public services is another. The vulnerability of property and contract rights to opportunistic behavior by government officials and other private actors is a third. The security of property rights and the incentives of politicians to guarantee secure property rights are most closely associated with economic growth. Their role in explaining economic growth in India and China are therefore the focus of this chapter.

The political definition of governance is the less usual, but it is key to understanding the dynamics of good governance. What are the characteristics of political institutions and competition that allow governments, particularly in China and India, to make credible promises to entrepreneurs that their investments will not be expropriated? The analysis below points to a variety of changes in the underlying process of governing, starting in the 1970s, that gave governments in the two countries an increasing ability to make credible promises to entrepreneurs.

That these two countries offer lessons for governance is surprising. Fast growth, and in the Chinese case, extraordinary growth, have been accompanied by strictly average governance indicators. From the 1980s to the present, international risk rating firms report that investors have confronted frequently arbitrary government decision making and insecure contractual and property rights. Poor countries might infer from these experiences that countries can fall considerably short of achieving good governance and still grow rapidly.

This chapter explores three reasons that explain why this inference is incorrect. First, broadly speaking, China and India were able to leverage policy reforms into sustained, fast growth, despite only average governance, because of their large markets and abundance of low cost labor. In smaller markets, the same policy and governance environment would yield slower

growth. Second, governance in China and India was better than in other poor countries. And third, in both countries, growth did not occur until significant improvements in governance occurred in the late 1970s and early 1980s.

Poor countries might also infer, based on the sharply different political institutions in China and India, that the particular political processes that lead to good governance outcomes are largely irrelevant. The evidence presented below suggests that this inference is also incorrect. At the same time as the policy changes that are widely and correctly credited with triggering growth in China and India, the two countries also experienced broadly similar political changes, particularly the introduction of greater political checks and balances on the top leadership. China has successfully navigated through different governance challenges in a political context without open political contestation. However, it has been able to do this only by creating political checks and balances inside the Communist Party that reduce the scope for opportunistic behavior by party leaders towards party cadres. For reasons identified below, this course is difficult for other countries to follow. For its part, India is one of the world's oldest democracies. However, political checks and balances weakened significantly in the 1970s; growth occurred after they were strengthened in the late 1970s.

Governance and Returns to Market Size in China and India

Growth took off in both China and India starting in the early 1980s. In China, per capita growth was approximately 8 percent per year in the 1980s, twice that of the 1970s. India's growth accelerated by a similar margin, rising from close to zero in the 1970s to 3.5 percent in the 1980s. India grew approximately twice as fast as the median country and China approximately *five* times faster. However, the role of governance in the growth explosion is difficult to discern.

Since we are concerned with country-level governance and growth, we can use a measure of governance widely employed for longer time periods, from Political Risk Services' *International Country Risk Guide,* to compare China and India to other countries. These measures reflect an *outcome-based* definition of governance.[1] At the beginning of the 1980s, the governance index calculated from ICRG was 9 for India and 9.3 for the world as a whole (out of a maximum of 18). At the beginning of the 1990s, the index stood at 9.6 for the world, at 10.0 for China and at 7.1 for India. (Higher scores indicate better governance.) Extraordinary growth performance evidently emerged from exceedingly ordinary governance.

Table 7.1 looks at a parsimonious set of correlates of per capita economic growth (in constant local currency) over the period 1980–2004 in a cross-section of countries.[2] Data are not available to estimate directly the growth effects of the types of policy reforms undertaken by China and India during this period. However, the principal factors identified earlier that affect country policy response to policy reform can be captured.

---

[1] The index is the sum of the *Bureaucratic Quality, Rule of Law,* and *Corruption* indicators in the *International Country Risk Guide* of Political Risk Services. These capture directly the main concerns of the governance debate and are frequently used in the literature to evaluate the effect of governance on growth and development (see Knack and Keefer 1995 and Acemoglu, Johnson and Robinson 2002). Though they are subjective measures, their estimated effects remain significant even when controlling for evaluator and other sources of bias.

[2] The log of initial income yields similar results, as does the use of exchange-rate weighted initial income rather than PPP-adjusted initial income.

Table 7.1 first allows us to show that Indian and Chinese growth, relative to that of other countries, cannot be explained by their governance levels near the beginning of their growth accelerations. In columns 1 and 4 in table 7.1, beginning of period income, governance, and percent of the population that is young, exhibit a large and significant association with growth. The estimated regression coefficient from column 1 explains about half of India's growth (the "India" coefficient indicates that 1.8 per cent of India's yearly per capita growth is unexplained). The column 4 regression explains less than half of China's actual growth (8.7 percent per year): the "China" coefficient indicates that China's actual yearly per capita income growth was five percentage points faster than can be explained by its income per capita, demographic, governance and other characteristics. It is easy to see from the estimations in columns 2 and 4 that governance does not explain the exceptional nature of Indian or Chinese growth. In these regressions, which omit the governance variable, the Indian and Chinese coefficients are nearly identical to the corresponding coefficients in columns 1 and 3.[3]

Table 7.1 Correlates of Growth, 1980–2004

Dependent variable: per capita income growth, constant local currency, periods 1980–89 and 1990–2004	(1)	(2)	(3)	(4)	(5)	(6)
		India			China	
China (1 = yes, 0 = no)				.050	.049	.007
				(8.10)	(7.44)	(.37)
India (1 = yes, 0 = no)	.018	.018	–.029			
	(4.79)	(4.59)	(2.61)			
Income per capita (beginning of period, in 1,000s of	–.0023	–.002		–.0002	–.0002	
constant, PPP-adjusted dollars)	(6.40)	(4.80)		(6.33)	(4.62)	
Population (beginning of period, in 100 millions)			.008			.006
			(5.22)			(3.05)
Total income (beginning of period, in trillions of			–.005			–.004
constant, PPP-adjusted dollars)			(2.82)			(2.29)
Governance index (beginning of period)	.0016		.001	.0016		.001
	(3.31)		(1.89)	(3.34)		(1.81)
Percent population 14 and under (beginning of	–.0016	–.002	–.0005	–.0015	–.0019	–.0005
period)	(3.57)	(4.62)	(1.22)	(3.46)	(4.51)	(1.29)
Percent population rural (beginning of period)	.00005	.00005	.0002	.00005	.00004	.0002
	(0.56)	(0.50)	(1.68)	(.53)	(.47)	(1.68)
Gross secondary school enrollment (beginning of	.00015	.00015	.0002	.0002	.0002	.0002
period)	(.23)	(1.18)	(1.27)	(1.33)	(1.31)	(1.22)
1980s (1 = yes, 0 = 1990–2004)	–.006	–.006	–.008	.–.006	–.005	–.008
	(1.82)	(1.70)	(2.24)	(1.74)	(1.62)	(2.28)
N (countries)	193 (112)	193 (112)	193 (112)	193 (112)	193 (112)	193 (112)
R^2	.35	.32	.27	.36	.33	.26

Note: The *t*-statistics are in parentheses. Ordinary least squares with robust standard errors (clustered). The governance index is the sum of Political Risk Service's *International Country Risk Guide* corruption, bureaucratic quality, and rule of law indicators. Constant not reported. A positive coefficient on the India or China variables indicates that growth is faster than predicted by the other control variables; a negative sign that it is slower than predicted.

Microeconomic evidence from China reinforces the conclusion that growth has proceeded despite a somewhat challenging governance environment. Cai, et al. (2005) find that firms make large payments to government officials (allocated to the budget item "entertainment and traveling costs" in company accounts) to offset bureaucratic burdens and the threat of opportunistic behavior by governments, rather than to create rents for themselves. Substantial firm level

[3] The governance variable is missing for China for the 1980s.

evidence also demonstrates that political intervention is a concern to firm managers and affects business decisions. Nee and Opper (2006) analyze a survey of 72 firms listed on the Shanghai Stock Exchange asking about involvement by either government agencies or Chinese Communist Party officials in 63 different firm decisions, ranging from finance and investment to personnel and external relationships. On average, firms report some involvement in all of these decisions. They also present evidence that the power of government bureaucrats and party authorities over firm decisions is negatively associated with firm return on assets and equity.

At the same time, good relations with the government are essential to credit access. Using data from the 2003 World Bank investment climate survey of China, Nee and Opper find, among those firms with access to credit, a striking reliance on administrative assistance from the government in the loan process. More than 40 percent of state-owned enterprises (SOEs), collectively-owned firms (historically, enterprises owned by townships or villages and managed by the governments of those jurisdictions), private firms and individually-owned firms that received government assistance also had a bank loan; only 15 percent of those that did not report assistance had a loan.[4] Political activity by CEOs is also significantly associated with credit access. For example, of private firms with CEOs who had official positions in the Chinese Communist Party , 32 percent received credit, compared to 17 of the firms with CEOs lacking this status (see table 7.2).[5]

Similar microeconomic evidence documenting rigorously the effects of specific governance lapses on firm behavior in India is not available. However, the evidence that access to basic economic inputs is often unrelated to market forces is strong. For example, firm access to credit from state-owned banks, which control the lion's share of credit in India, seems largely unrelated to firm profitability nor to changes in firm profitability (Banerjee, Cole, and Duflo 2003). There is no direct evidence that individual political connections of firms assist them in breaking through the inertia of the credit approval process to increase their access to credit; the returns to doing so, however, appear to be high.[6]

Table 7.2 Politically Active CEOs and Proportion of Firms with a Bank Loan, by Ownership Form
percent

	SOE	Collectively owned firm	Listed firm	Private firm	100 Percent individual ownership firm
CEO without party office	15.97	14.88	66.66	16.99	16.72
CEO with party office	24.83	14.02	40.00	32.17	32.17

Sources: Nee and Opper 2006, table 7; data from 2003 World Bank Investment Climate Survey of 2,400 Chinese firms.
Note: CEO = chief executive officer.

[4] It is not clear whether government assistance is sensitive to factors that competitive credit markets would in any case take into account. Nee and Opper (2006) find significant positive correlations between government assistance and an innovation index, but none with profits or debt-asset ratios. Size of the labor force and whether firms are in manufacturing are highly positively associated with government assistance. These could be relevant to the market if large firms and firms with more collateralizable assets are more creditworthy; or they could simply reveal political incentives to protect employment and manufacturers.

[5] These effects are also significant in a logistic regression that controls for whether firms report a need for loans, sector and regional controls, firm ownership, firm age, labor force, etc. See Nee and Opper (2006).

[6] Although credit rationing is clearly significant in India, Mengistae, Xu and Yeung (2006) find that Chinese firms are actually more responsive to credit access than Indian firms. Using World Bank investment climate data, they find that in both countries, firms in cities that exhibit better average firm access to a bank credit line (overdraft protection) are more productive and exhibit faster growth in employment and manufacturing value-added. However, the effect is much stronger for Chinese firms.

Why have India and China experienced stellar growth, if their policy and governance environments are less than stellar? One explanation is simply the size of their potential markets and of their low cost labor pools. The specifications in columns 1, 2, 4 and 5 in table 7.1, although traditional in both their parsimony and reliance on initial per capita income, do not tell us about the potential effect on investors of market size. Two such indicators are total income and total population. These are restricted to exhibit the same effect on growth in regressions that control for initial income per capita, a restriction that is violated if population and country income affect investor incentives differently. This is particularly problematic in the case of India and China, with total incomes approximately one standard deviation larger than the world average in 1980, but with populations more than five standard deviations larger.

Columns 3 and 6 in table 7.1 therefore omit initial income per capita, substituting beginning of period total income and total population. The results indicate that every 100 million person increase in total population is associated with a 0.6 percent annual increase in the growth of per capita income, consistent with the advantages of larger potential markets for products and larger labor markets. Country income captures two offsetting effects: the market is smaller in countries with low total incomes, deterring investment, but poorer countries have lower wages and greater potential for catching up, raising growth rates. The latter effect dominates: every trillion dollar *decline* in total income is associated with a 0.4 percent annual increase in growth.

This slight change of specification in column 6 predicts Chinese growth almost entirely. Actual Chinese annual per capita growth was only 0.7 percentage points faster than predicted by the control variables. These results suggest that policy changes in China allowed investors to take full advantage of the immense Chinese market, despite modest protections of property and contract rights. On the other hand, more directly accounting for market size in India reverses the sign of the India coefficient. Rather than growing 1.8 percentage points faster than expected in columns 1 and 2, Indian growth was 2.9 percentages points *slower* than predicted by the control variables. India's policy reforms allowed entrepreneurs to take some advantage of the market, but the country grew less rapidly than its market size would suggest. Reforms in the two countries are briefly discussed below: the more limited reforms undertaken by India may explain the negative sign of the India variable in column 3.

One might argue that the market advantages of China and India are over-stated here. In both countries, markets are splintered by uneven transportation networks and protective trade barriers set up by regions within these countries. However, these barriers exist as well in small countries and are often worse (between India and China, Nepal confronts worse transportation constraints because of geography and Nepali towns have, like Indian and Chinese locales, been known to apply such internal trade barriers as octroi taxes on goods passing through them).

In addition, investors in India and China may not be attracted by the domestic market, but instead may have primarily sought out markets for their export-based production facilities. Consistent with this skeptical view of market size, exports as a share of GDP rose from approximately 10 percent in 1980 to approximately 20 percent in 2000 in China, and in India from 6 to 12 percent of GDP. Meanwhile, household consumption remained at approximately 50 percent of GDP in China and dropped from 74 to 65 percent in India. However, even if household consumption shares stagnated or fell relative to exports, total domestic consumption increased significantly in both countries, since per capita incomes more than doubled in India over the period and nearly quintupled in China. This increase was supplied in large part by new domestic production capacity.

At the same time, the size of a country offers other advantages to exporters. These range from any agglomeration economies that might exist to deeper liquid labor markets (any single new entrant is unlikely to increase wages). In addition, Kochhar, et al. (2006) attribute Indian

success to the virtues of experimentation and learning by doing; the number of experiments that an economy can conduct rises in the size of the economy.

Evidence from foreign direct investment reinforces the conclusion that the potential returns to investment drove fast growth in China. Holding the policy environment constant, we would expect foreign investment to gravitate to where the prospects of future growth were highest. Fan, et al. (2006) compare foreign direct investment received by China relative to the rest of the world. They conclude that the burst of FDI into China in the 1990s was essentially driven by high expected growth (as represented by high past growth) —that is, by the enormous opportunities presented by the Chinese market, which were significantly opened to foreign investors by policy measures undertaken in the late 1980s and early 1990s. FDI into China is perhaps 80 percent greater than in comparator countries because of expected rates of return. This effect dominates the (also large) influence of the institutional environment, which suppresses foreign direct investment in China by approximately 30 percent.[7]

Large markets are clearly not sufficient for growth. However, large market size appears to be the critical factor that drives sustained, fast growth in the presence of merely average governance and policy indicators. The lesson for other poor countries is clear: they cannot grow fast if they simply match the governance and policy environment of China or India, because they cannot match the potential returns offered by the large markets and pool of low-priced labor in the two countries. This point can be made more strongly: as the next section shows, early on, as their growth accelerated, governance levels in the two countries were already substantially better than in countries with similar incomes per capita.

China, India, and Governance in Poor Countries

Not only have China and India enjoyed advantages in terms of market size compared to other poor countries; the average governance levels they have achieved are better than in most other poor countries. One way to see this is to ask how much China's and India's actual governance levels exceed or fall short of what we would predict based solely on the world relationship between income per capita and governance. Table 7.3 illustrates that actual governance levels in China and India exceeded those of countries with similar incomes per capita by roughly three and two points, respectively in 1985 and 1990. These are large differences. Their governance levels exceed the average of all countries by more than one-half a standard deviation; they are more than 1.5 standard deviations in excess of the average lower-income country.

[7] Huang (forthcoming) argues that Chinese policy has been significantly friendlier to foreign than to domestic investment. This reinforces the essential point: foreign investors have flocked to China because high expected rates of return offset a governance regime in which property and contractual rights were moderately insecure.

Table 7.3 Actual Minus Predicted Governance

Residuals from	Based on income per capita		Based on total population and total income	
	1985	1995	1985	1995
China	3.12	3.27	2.64	1.82
India	2.03	1.80	.65	1.04
Mean governance (standard deviation)—all countries			9.64	11.32
			(4.32)	(3.67)
Mean governance (st. dev) GDP/capita < $5,000 (PPP-adjusted, constant)			7.31	9.09
			(2.95)	(2.07)
Actual governance, China			10	12.7
Actual governance, India			9	11

Note: Predicted governance either from a regression of the ICRG governance index (as in table **7.**1) on income per capita in 1985 or 1995, or from a regression on total population and total income.

Better governance, in and of itself, therefore endowed China and India with better development chances than the average poorer country, above and beyond the advantages the two countries enjoyed because of policy changes and market size. Table 7.1 allows a rough estimate of the magnitude of this advantage to be assessed. A 1.5 standard deviation increase in governance, from column 1 of table 7.1, would have been associated with more than a one percentage point increase in yearly per capita growth over the period 1980–2004.

Moreover, better governance made it easier for China and India to exploit their market advantages. As the prospect of government expropriation rises, any given inducement to invest, whether policy liberalization or an increase in the size of the market, has less of an effect on investors and growth. Keefer and Knack (1997) show this to be the case for the "catch-up" effect—the advantage that a poor country should demonstrate simply because its wages are lower and returns to capital are higher. Poor countries with good governance do, in fact, exhibit faster growth than rich countries; those with a difficult governance environment, however, actually grow more slowly. The difference in growth rates per capita between the two groups of countries exceeds 3 percentage points per year.

Beneath the Cross-Country Data: Political Change and Governance Outcomes in India and China

Two conclusions emerge from the analysis above: first, although governance outcomes in China and India were challenging for entrepreneurial activity, they were better than in other poor countries, first, and, second, moderately insecure property rights were in any case offset by the attractions of large markets. As a consequence, policy reforms had a larger effect than would have been the case in smaller poor countries with more fragile governance. One further phenomenon underlines the importance of governance in the economic success of the two countries: in both countries, governance was poor in the 1970s and improved, together with policy, at about the same time that growth began to accelerate.

There is little data to track governance outcomes in the two countries from the 1970s onwards, since such measures first appeared in the 1980s. We can, however, track those political characteristics of the two countries that affect political incentives to pursue better governance outcomes. Identifying the political characteristics that matter for governance is not entirely straightforward, however.

For example, one might expect the prospect of re-election would generate greater interest on the part of political leaders in broad social welfare. An influential literature argues precisely this: elections prevent elites from expropriating non-elites, thereby encouraging non-elite investment and growth (as in Acemoglu and Robinson 2006). China and India demonstrate that elections are neither sufficient nor necessary to improve governance outcomes. More broadly, governance scores in countries with competitive elections differ little, on average, from those in countries without.

In 1995, for example, countries in the fiftieth governance percentile of all countries with competitive elections was nearly the same as the score in the fiftieth percentile of countries without them (11 versus 10.7 out of 18).[8] In some democracies, elections offer no incentives to improve governance outcomes. In some countries without competitive elections, leaders have stronger incentives to secure the governance environment.

The arguments pointing to the efficacy of elections are intuitively appealing. The lower the cost to citizens of expelling non-performing officials, the more we would expect officials to act in the interests of citizens. In practice, however, electoral markets are often highly imperfect, disrupting electoral accountability and the ability of citizens to sanction governments that allow poor governance outcomes to persist. One key political market imperfection is uninformed citizens. If citizens cannot draw a connection between public policy and their own welfare, neither elections nor other, non-electoral means of expelling politicians easily limit governance abuses by government officials. Citizens may not understand the relationship between political decision making and their welfare, perhaps because of substantial delay between government actions and welfare changes (for example, banking crises triggered by corrupt financial sector regulation may not emerge until years after corrupt regulatory decisions are made); or shocks cloud the ability of citizens to assess political contributions to their welfare. India experienced a number of significant shocks in the 1970s that had this effect.

A second political market imperfection arises when the promises of politicians are not credible. For example, if the leaders of non-elite parties cannot credibly promise to non-elites that they will refrain from expropriating non-elite investments, the introduction of elections in unequal societies does not necessarily result in faster growth. Parties struggle to build reputations for preferring particular policies or for serving particular groups of citizens better than their opponents. When political competitors cannot make broad promises, they resort to appeals to those narrow groups of citizens to whom they *can* make credible promises—but when those groups are narrow, incentives to improve governance for all citizens dwindle (Keefer and Vlaicu 2005). An important aspect of the political history of India that underlies changes in the governance environment is the emergence of credible political challenges to the Congress Party.

Political market imperfections are more acute in countries beset by deprivation or profound social polarization. Isolated and poor populations are less likely to know of the relationship between political actions and the governance environment, or to appreciate the importance of the country's governance environment for their own personal well-being. Similarly, in countries riven by social tension, the costs of making credible political promises to all citizens dwarf those of making promises targeted to individual groups. Each political competitor belongs to one of the groups and is therefore mistrusted by all the others.

Political checks and balances also play a significant role in improving governance outcomes. They limit the ability of narrowly focused parties or individual decision makers to act

[8] Countries are categorized as having competitive elections when they score the maximum (seven) on both the executive and legislative indexes of electoral competitiveness, from the Database of Political Institutions (Beck, et al. 2001).

unilaterally in their own interests. Efforts to divert resources for private benefit, or to expropriate some citizens to favor others, are all more difficult in the presence of political checks and balances. More obviously, political checks and balances limit the chances that any one leader will embark on disastrous policy experiments.

Regardless of whether they face competitive elections, political leaders pursue good governance outcomes to the extent that it helps them remain in office. If improving the economic welfare of all citizens is a cornerstone of the leadership's political strategy in a country without competitive elections, then the leadership has a strong incentive to pursue good governance. They can do this if they build a large ruling party and develop intra-party institutions that allow them to make credible promises to party members. The logic here is straightforward: government leaders cannot convince average citizens that they will not expropriate their investments, since average citizens have no easy way to punish such expropriation. However, if government leaders can make credible promises to party members, the larger the number of party members, the greater is investment, and the greater is the demand for the labor of average citizens. The key change in China from the 1970s to the 1980s was the introduction of institutions that constrained the discretion of the top leadership towards the large membership of the Communist Party.

Large parties, organized to protect members from arbitrary decisions by the party leadership, are costly for leaders to establish; hence, their rarity (Gehlbach and Keefer 2006). For example, a necessary condition for party member loyalty is that members receive larger rents than they could outside the party. As their number rises, so too does the share of rents party members as a whole receive.[9] All of the intra-party institutions that make promises to party members credible also require leaders to surrender rents. Intra-party checks and balances reduce the rent share of any individual leader. Investments in elaborate intra-party evaluation and promotion processes, such as those China introduced in the 1970s and 1980s, enhance credibility, since the investments are lost if the criteria are violated. They also are expensive. Regular turnover of the party leadership and rule-based succession improves the credibility of leaders, but these obviously reduce the share of rents that flows to party leaders.

Institutionalized parties in settings without competitive elections are therefore less likely where large rents can be extracted from little investment; President Sese Mobutu, for example, made no attempt to create a broad-based, institutionalized political party in Zaire, choosing instead to personalize government and to treat even close supporters unpredictably. The huge rents available from natural resources (copper) explain this strategy: the gains from credibility (higher rents from productive investment) were offset by the natural resource rents he would have lost if he had had to share them with a broad, institutionalized party.

Power sharing is also less likely when a single leader of the unelected government commands disproportionately more influence (military, popular or otherwise) than the others. When this is not the case, political checks and balances emerge naturally, as the consequence of a balance of power among key leaders. When the distribution of power within the leadership group is unbalanced, as in China under Mao Zedong, political checks and balances are difficult to establish.[10]

---

[9] The exception here is ideological motivation. To the extent that party leaders can use ideological appeal to mobilize followers, they can provide fewer financial rents to supporters.

[10] Even when they exist, checks are only effective when the interests of at least one political veto player are harmed by expropriatory behavior, giving the veto player an incentive to block expropriatory decisions by the government. North and Weingast (1989) argue that the Glorious Revolution in Great Britain ushered in a period of prosperity by institutionalizing the check of an elite-dominated parliament on the monarchy. Stasavage (2003) demonstrates, however, that the effects of institutional change following the Glorious Revolution varied with the composition of the

Although intra-party institutions matter most in countries with only one ruling party, they are also relevant in democracies where one party is dominant, as the Congress Party was prior to 1977 and in the last half of the 1980s. As the discussion below highlights, a key feature of Indian democracy in the 1970s was the weakening of intra-party constraints on Congress Party leaders. In the 1990s, in contrast, extra-party constraints on leaders strengthened, via the political checks and balances imposed by coalition governments and by the growing credibility and electoral viability of competitors to the Congress Party.

The emergence of credible political competitors of the Congress Party and the development of political checks and balances are the key political changes in India and China that preceded their growth accelerations. In China, political checks and balances evolved entirely within the Chinese Communist Party. In India in the 1970s, intra-party and intra-governmental political checks and balances broke down. In the 1980s and 1990s, checks and balances were restored and strengthened, particularly with the emergence of credible political challengers to the Congress Party.

Political Change and Governance in India

Most explanations of Indian growth focus on the 1990s and point to the major policy reforms of 1991 as growth triggers. However, average annual per capita growth in India was the same in the 1980s as the 1990s at about 3.5 percent, compared to less than one percent in the 1970s.[11] In an exhaustive exploration, Rodrik and Subramanian (2004) find no evidence of significant policy changes that would explain the 1980s Indian growth acceleration. They suggest instead a less tangible change in the attitudes of Indian governments towards the private sector. However, Kohli (forthcoming) details policy thrusts of the early 1980s that, though modest, seem to have marked a shift away from a socialist, redistributive development model to one friendlier to incumbent private business interests and more antagonistic towards labor. This section points to a complementary explanation of faster growth in the 1980s relative to the 1970s. In the 1970s, the policy and governance environments steadily deteriorated. The simple cessation of this deterioration, in addition to the relatively small improvements in policy, was probably an important trigger of growth in the 1980s.

Policy deterioration during the 1970s, precipitated by the elections of 1967, is well known. The Congress Party's share of seats in the Parliament dropped by 19 percent to a majority of 54 percent. The costs of defection from the party dropped significantly, as a consequence, and the party itself began to splinter. Indira Gandhi chose to build support among the socialist and interventionist wing of the party by pursuing a dramatic increase in the state's role in economic activity.

The government nationalized the major banks and steadily increased the profile of state-owned enterprises. Shanker and Nayak (1983) estimate that the gross value added of state-owned companies rose from 15 percent of the share of the combined value added of government companies and non-government non-financial medium and large public and private limited companies in 1968–69 to 26 percent in 1977–78. The "licensing Raj" also expanded dramatically.

Parliament. The British Crown bitterly resisted the emergence of this check on its authority and it is easy to see why: a strong parliament restricted its access to rents.

[11] Income is measured in constant local currency. Volatility also dropped significantly; the standard deviation of annual growth in the 1970s was more than twice the standard deviation in the 1980s and 1990s. Volatility is relevant to the discussion here: Quinn and Woolley (2001) show that democracies exhibit less volatile growth more generally.

In 1970, all large enterprises were required to register with the new Ministry of Company Affairs and could not expand without approvals from a range of ministries and, in problematic cases, from the prime minister herself. In 1976—marking at least eight successive years of growing restrictions on entrepreneurial activity—amendments to the Industrial Disputes Act obliged firms with 300 or more workers to seek government approval before laying off workers (Frankel, p. 438).

Weakened governance during the 1970s is less often discussed in the context of India's growth in the 1970s and 1980s. Some of the policy changes themselves were already evidence of weakened governance. The application of the licensing Raj was not transparent and bank owners were effectively expropriated—not fully compensated for the losses they suffered from nationalization. In addition, though, the political drivers of good governance outcomes weakened in the 1970s in India.

First, political checks and balances inside the Congress Party diminished during this period. Prior to 1967, competing interests comprised the Congress Party and these were able to limit the discretion exercised by any one of them. Leaders of the Congress Party ranged from the anti-industrial Mahatma Gandhi wing of the party to the pro-industrial but socialist wing represented by Nehru to militants prepared to take up arms in pursuit of redistributionist aims. Less ideological leaders, those who managed the Congress' well-developed clientelist network that was key to voter mobilization, were also prominent. Frankel describes this network:

> In general, national political parties did not recruit from among the poor peasantry. Instead, they accommodated themselves to the existing power structures as the easiest way to win votes. . . [T]he major beneficiaries of [adult suffrage] were the most prosperous sections of the dominant landowning castes, individuals who could exploit a wide network of traditional caste, kinship, and economic ties (of dependent sharecroppers and laborers) to organize a large personal following (p. 20).

The interests of these landowning castes were therefore amply represented in Congress and could also veto policy change. In 1946, the most powerful man in the Congress party was Sardar Vallabhai Patel, Mahatma Gandhi's chief lieutenant, who was responsible for building up the local party. He frequently prevailed in conflicts with Nehru, for example, by blocking socialist candidates for Congress party leadership (Frankel, p. 72) and only upon his death was Nehru able to push forward in promoting state-led industrialization (Nayar, p. 30).

After the 1967 elections, Mrs. Gandhi began to ignore intra-party constraints on her authority. She appealed to younger, more radical members of the Congress Party to shore up her support, an effort to which bank nationalization made a significant contribution. This precipitated a split of the party in November 1969 in which opponents of Mrs. Gandhi left the party, weakening intra-party checks and balances.[12] Further evidence of the decline in checks and balances emerged shortly after the 1969 split. Mrs. Gandhi took key functions of government out of the control of Cabinet ministers and put them under her direct control. In 1970 she transferred 60 of the 100 sections of the home ministry (and 7 of 14 joint secretaries) to the Cabinet

[12] She formed the Congress-R Party (later I, for Indira); senior Congress officials formed the Congress-O (Organization) Party.

secretariat, bringing under her personal oversight the major administrative, policy and intelligence services of the national government (Frankel p. 450).

The split in the party need not have led to a reduction in political checks on the exercise of executive discretion if it had forced the Congress (I) party to govern in coalition, replacing intra-party with external checks, or if it had been followed by a strengthening of intra-party checks in Congress (I). Neither of these happened. In the 1971 elections the re-fashioned Congress Party (I) increased its parliamentary majority to 68 percent. In addition, leadership incentives to increase internal checks and balances, strengthening party organization and depersonalizing party leadership weakened substantially with the onset of numerous crises. These included both international foreign policy crises and domestic economic shocks. The ability of the leadership to make credible promises to followers dropped substantially: followers, even if they believed the leadership would abide by its commitments, had less reason to believe that the Congress Party would remain in office long enough to fulfill these commitments. Instead, the reverse occurred and the prime minister saw widespread challenges to her authority; she could not accommodate these with promises of future policy payoffs and her government lacked the financial wherewithal to accommodate them with budget allocations.

Following the election, India was struck by monsoon failure and food shortages, a quadrupling of oil prices triggered economic crisis starting in 1973 and inflation exceeding 23 percent over the period 1973–74 (Frankel p. 647 and Brass 1990 p. 40). Large and sometimes violent public demonstrations accompanied these shocks. Massive student-led demonstrations in Gujarat and Bihar led the government to send 40,000 troops to Bihar. Activists and demonstrators eventually earned the support of Jayaprakash Narayan, widely respected for his proximity to Mahatma Gandhi and his support of the poor and, after evolving into the "J.P. Movement," became an India-wide movement to challenge Indira Gandhi's government within and outside the parliament (Frankel 531–34). In 1974, 700,000 railway workers went on strike—half of the sector's workforce—which ended 20 days later, after the government had arrested most of the union leaders and 20,000 of the workers (Frankel 530). In 1975, the first assassination of a Cabinet minister since Independence occurred with the bomb explosion that killed railway minister L. N. Mishra (Frankel p. 530). In June 1975, the High Court of Allahabad found Prime Minister Indira Gandhi guilty of illegal electoral manipulation and ordered her to vacate her seat.

Faced with a foreshortened political horizon and the high costs of retaining her supporters (who themselves foresaw difficulties for Congress), in 1975 Mrs. Gandhi declared an Emergency, definitively relaxing most constraints on her authority. Her supporters arranged for the detention of thousands of local-level party workers (Brass 1990, p. 42). She arrested her principal opponents and postponed parliamentary elections scheduled for 1976 (thereby weakening legislative checks on executive authority) (Brass 1990, p. 42); and she arranged for the passage of the 42nd amendment to the Constitution in late 1976, which made the Cabinet's advice binding on the President, removing the president as a constraint on prime ministerial discretion.

The 42nd amendment also undercut judicial oversight of the executive. This oversight had been vigorous. For example, the Supreme Court rejected almost immediately the 1969 bank nationalization and government efforts to abolish the privy purses and privileges of ex-princely rulers. The government was able to legislate around the rejection of nationalization but not of the privileges of the former princes. Even more indicative, immediately preceding the declaration of Emergency, in 1975, a lower court ruled that Prime Minister Gandhi should resign because of electoral misconduct. The 42nd amendment that followed the emergency declaration gave primacy to Directive Principles (that is, constitutional goals related to the pursuit of social justice, and whose pursuit was subject to substantial executive discretion) over Fundamental Rights. This undercut much of the constitutional basis of judicial review. For example, the Court had used

Fundamental Rights to justify the defense of property rights in the case of bank nationalization and princely privileges (Frankel p. 654).

In sum, the 1970s not only witnessed significant policy deterioration with respect to private sector activity, but also a deterioration in the governance environment—bank nationalization and a chaotic political environment marked by a reduction in the checks and balances operating on the executive, and a foreshortened political horizon. It is not surprising that growth was slow in the 1970s. Even a flattening of the steadily less investment-friendly trend of policy and governance could be reasonably associated with the resumption of growth in the 1980s.

The End of Turmoil: Governance and Policy Reforms at the End of the 1970s

In fact, a halt, and in some cases a reversal of these trends began in 1977. For reasons that are still debated, Mrs. Gandhi called for new elections that year. They resulted in a massive reversal for the Congress Party and the ascent to government of the Janata coalition. On both the policy and governance fronts, these elections marked the end of the deterioration in the policy and governance environment. Modest policy reforms signaled this change: expanded coverage of the open general licensing list; more liberal access to credit and foreign exchange; delicensing, and measures that expanded the range of products that could be produced under any given license; and some relaxation of price controls (see Kohli, forthcoming and Kochhar, et al 2006). However, the clearest indication of the Congress shift to the right was the decision of the Communist Party to abandon its alliance with Congress, which it had maintained since 1969 (Frankel 656).

The governance environment also improved. First, formal, institutional checks and balances were restored. The Janata government repealed the 42nd amendment and passed the 44th amendment, largely restoring the pre-Emergency constitution and the predominance of fundamental rights. Though in the process the government also removed property as a Fundamental Right, these constitutional actions rolled back earlier infringements on the autonomy of the Supreme Court. Moreover, in practice, the Supreme Court reestablished its right to review the consistency of laws with the Fundamental Rights of the constitution in the Minerva Mills case in May 1980 (Frankel 657).

Second, the 1977 elections marked a new era in Indian politics in which challengers to the Congress Party could actually take control of government. The 1977 elections did not restore intra-Congress checks on leadership discretion that had existed in the 1960s. However, they substantially reversed the deterioration in the governance environment in another way, by introducing electoral checks that had not previously existed. The 1967 election is sometimes taken as a watershed that ended Congress hegemony. However, although the Congress Party received only 41 percent of the popular vote, its closest challenger, the Bharatiya Jana Sang, received only nine percent. The 1977 elections were the first that demonstrated that the Congress Party could actually be driven from government. They definitively demonstrated that no government in India was safe from poor performance, and that multi-party competition in India was resilient even in the face of such extra-institutional intrusions as mass demonstrations and declarations of Emergency.

None of this is to say that in the 1980s, India became a model of coalition government and institutionalized decision making. The Janata government used all the formal and informal instruments at its disposal in attempting to remove state governors who had come to office under the Congress era. Then, in 1981, Congress returned to power with a majority of seats in the Lok Sabha. In the 1984 elections, following religious riots and the assassination of Indira Gandhi, the Congress Party won over 70 percent of the seats in the national legislature. As the new prime

minister, Rajiv Gandhi was able to govern unchecked by the presence of coalition partners. A number of efforts to improve governance, such as police reforms, were aired but went nowhere.

Nevertheless, in contrast to the period following the 1971 elections, even Congress governments with overwhelming majorities governed in the knowledge that they could be expelled from office. On the one hand, the Congress plurality of victory in many of the single-member districts continued to be slight, as it was in 1971 elections (Congress won nearly all of the more than 80 seats in Uttar Pradesh with less than 50 percent of the vote in the state). On the other hand, though, the 1978 elections had brought a credible opponent to power, underlining that performance failures by the Congress Party—including the negative economic consequences of bad governance outcomes—could be sanctioned with electoral defeat.

One final piece of evidence for the governance transition comes from Business Environment Risk Intelligence, which reports information for 45 countries beginning in 1972, among them India but not China. One of the dimensions of governance that BERI tracked in the 1970s was the quality of contract enforcement. This variable rose (improved) from 1.15 to 1.93 (on a four point scale) from 1979 to 1980. This was not the product of a change in methodology or a secular improvement; the median of the whole sample of countries (45) dropped slightly (2.43 to 2.3).

Governance and Policy Reforms in the 1990s

In 1991, the minority Congress government led by Narashimha Rao undertook the most significant moves towards economic liberalization that India had seen since Independence (though as Kohli, forthcoming, notes, Congress was already making pro-business overtures under the Rajiv Gandhi government). The initial impetus of the reforms was crisis: foreign lending on which India had relied in the 1980s dried up, debt service rose to 21 percent of current account receipts and interest payments to 20 percent of government expenditures. The Rao government, however, issued executive orders that went well beyond the narrow fiscal sources of crisis and dramatically cut back the number of industries reserved for the public sector; removed compulsory licensing on the private sector for starting or expanding enterprises; devalued the rupee; allowed for current account convertibility; removed quantitative import quotas and reducing tariffs; lifted restrictions on foreign investment and allowed foreign financial institutions to make portfolio investments in India's two stock markets. However, more aggressive actions, such as reductions of major subsidies, privatization; the recovery of bad loans in the banking sector; and fewer tenure protections for workers, required the agreement of the Lok Sabha and were not undertaken (Kohli, forthcoming).

The 1990s have also seen a consolidation of political checks and balances, with alternation in control of national and state governments and regular coalition governments. One indication that checks and balances has increased is the increase in political fragmentation in India from the 1980s to the 1990s. The probability that two randomly selected legislators would be from different parties rose from approximately 50 percent in the 1980s to 70 percent in the 1990s (*Database of Political Institutions,* Beck, et al. 2001). Coalition governments became imperative in the 1990s: the probability that two legislators in the government coalition were from different parties was more than 30 percent in the 1990s and less than two percent in the 1980s. Obviously, fragmented political parties distinguish India from China, but India is hardly exceptional among democracies. For all parliamentary democracies in the 1990s, the probability that two legislators in the parliament were from different parties was approximately 67 percent.

When Congress returned to power in 2004, it again allied with the Communist (CPI-M) and other left wing parties to form a majority. In the 1970s, such an alliance precipitated factors that deepened government interventionism in the economy. The policy effects of the alliance have

been much different in 2004. While it has not presaged economic liberalization, it has not reversed the 1991 reforms. Instead, equity and redistribution have been pursued through jobs-for-work programs; the efficiency costs of such programs are of a different order of magnitude than nationalization and import quotas.

Still, growth in India has not accelerated from the rate of the 1980s, and its growth continues to lag considerably behind China's. The 1991 reforms lifted many restraints on incumbents, but India has been reluctant to open its markets to new entry, either domestic or foreign. Kohli (forthcoming) attributes this restraint to a political alliance between politicians and incumbent firms, leading to policy reforms that encourage incumbents to invest, but that do not allow broad entry.

One reason for the difficulty of securing further growth reforms subsequent to 1991 is simply popular opposition. Wilkinson (2006) cites survey results after the 2004 election showing only 29 percent of voters favored reducing the number of state employees and only 22 percent favored privatizing public sector enterprises. Between 60 and 70 percent of Indians believe that the middle class and rich will be the primary beneficiaries of economic reforms. These are much different attitudes than prevail in China. However, India also exhibits a number of political characteristics that make it more vulnerable to efforts by special interests to block growth-promoting reforms, such as improved governance. These same characteristics reinforce the perception that the benefits of reform are unlikely to be widely shared.

One might argue that party fragmentation itself is a cause of this reluctance. Smaller political parties appealing to more narrow constituencies have fewer incentives to pursue policies in the broad national interest. However, the large income gains that these parties seem willing to forego suggest deeper reform obstacles. These are related to the political market imperfections discussed earlier.

In a large, poor country with many social groupings, it is difficult for parties to base their electoral appeal on growth-related policies. These are hard for poorly informed voters to observe. In addition, their effects cut across social lines. However, if politicians are looking for the support of particular social groups, they much prefer policies that benefit these groups exclusively. The policy preferences that emerge from this political environment are clientelist promises or easily targeted and observable government policies, such as subsidies (see Wilkinson, forthcoming). So, for example, not only are market-opening reforms difficult, so are efforts to improve the quality of the bureaucracy, reduce corruption or to eliminate continuing significant regulatory impediments to growth are more difficult because they conflict with, or are irrelevant to, the electoral basis for political success.

One way to see how special interests continue to prevail over public need, despite the presence of political checks and balances and meaningful electoral competition is in infrastructure. The availability of infrastructure is widely agreed to be a significant bottleneck to Indian policy. Nevertheless, infrastructure spending collapsed in the 1990s in India, falling back to its levels of the 1970s, approximately 1.5 percent of GDP, from amounts exceeding two percent of GDP in the 1980s. This collapse is of course related to macroeconomic and fiscal problems.[13] Macroeconomic problems do not explain the allocative distortions in infrastructure, however, towards projects with the greatest political payoff, and the persistent difficulties in attacking bottlenecks that impose the greatest obstacles to economic growth. Here, the

[13] This explanation is easy to overstate, however. The reallocation of spending away from politically attractive but non-productive and scarcely equitable subsidies and improved tax administration would probably be sufficient to fund productive infrastructure.

imperatives of electoral competition in the presence of political market imperfections provide a better explanation (Wilkinson 2006).

Chinese Governance in the Post-Mao Era

The policy and governance environment in China prior to 1980 is well known as one particularly hostile to private enterprise and market incentives. Until Mao Zedong's death in 1976, private enterprise was essentially illegal; the prohibition was strictly enforced. Governance was also difficult. Under Mao, China embarked on policy adventures, from the Great Leap Forward to the Cultural Revolution, which severely disrupted Chinese society and the lives of both average citizens and of Communist Party cadres. Shirk (1993) notes that, prior to 1978, "Mao Zedong attempted to sustain his revolutionary charisma and stem the trend of institutionalization . . . by launching mass campaigns such as the Great Leap Forward and the Cultural Revolution." (p. 8). Thousands of party officials were transferred to lower-level jobs, sent to the countryside for re-education or imprisoned during the Cultural Revolution (Shirk p. 15). Elite politics under Mao were particularly unpredictable, again signaling the lack of constraints on opportunistic behavior. Two of Mao's "chosen successors" died politics-related deaths (Whiting p. 11). The Cultural Revolution itself represented an effort by Mao to bypass the Communist Party and his opponents within the party, and was instead implemented by the Red Guards, whom Mao directly controlled.

The policy environment in China under Mao did more to suppress entrepreneurial initiative than it did in India prior to 1980. Political credibility and checks and balances were similarly weaker than in India during this period, 1952–1980. Individualized rule and highly arbitrary decision making, yielding a strong sense of insecurity in both party and non-party members, are the uncontested and widely known characteristics of this period of Chinese history. Economic growth exploded after *both* policy and governance reforms.

From 1952–1980, average individual incomes increased by less than 2.5 percent per year (Shirk p. 28). From 1980 onwards, growth tripled. Agricultural production rose at a yearly rate of 7 percent from 1978–1988, more than three times faster than in the previous 26 years (Shirk 40). Manufacturing boomed. Between 1978 and 1987, non-state rural enterprises rose from 8.7 to 23.1 percent of all industrial output (Byrd and Gelb, table 3).[14] The share of total industrial output produced by non-state firms, those not controlled by the central government, almost doubled from 1978 to 1988, from 22 to 43 percent (Shirk 48).

The Credibility Puzzle in Chinese Growth

The policy reforms underlying these changes were dramatic and are by now common knowledge. By 1983, the household responsibility system, making households residual claimants of production on their collectively owned plots, had spread throughout China. Key policy changes also stimulated private sector industrial development, both as a strategy to employ the millions of surplus workers released from agricultural work by decollectivization, and as a way to restore the influence and rents to local cadres that they had lost as a result of decollectivization (Oi 1999, p. 76). Farm households were allowed to invest profits in farm machinery, trucks, industrial

[14] About 2/3 of these enterprises were owned formally by townships and villages in 1987, and about 1/3 by private individuals or groups.

equipment and to engage in private marketing and manufacturing. Collectively-owned township and village enterprises could be leased to individuals and groups (Shirk 38). Rural investment loomed large: private firms in the rural sector accounted for 19 percent of total fixed asset investment in the 1980s and township and village enterprises, TVEs, another 13 percent (Huang, forthcoming). Decisions in 1979 expanded foreign trade and allowed foreign companies to invest in Chinese enterprises. The central government also decentralized the administration of foreign trade and investment, allowing localities to deal directly with foreign interests.

Local government officials were at the center of these reforms. They implemented decollectivization, since land was still collectively owned at the local level. They hired the managers of the township and village enterprises. As Oi (1999, p. 25) observes, although TVEs were usually contracted out by town and village governments to private managers, local governments—and the party officials who ran them—retained control of personnel, investments, product lines and, ultimately, were residual claimants of profits. Whiting (2001, p. 204) writes that "Indeed, township officials themselves approved the number of employees and the total wage bill of each enterprise."

It is likely, though here the evidence is limited, that local officials were also closely involved with the non-TVE private enterprises. On the one hand, much rural private investment was driven by agricultural liberalization, where the key asset, land, was controlled by local officials. On the other hand, some evidence points to feelings of substantial insecurity among private investors during the 1980s. In resource-poor Wenzhou City, local officials had below-average access to revenues with which to finance TVEs and were therefore eager to encourage private enterprises. Private entrepreneurs, however, operated without the explicit legal guarantees that TVEs enjoyed. Their concern about expropriatory behavior, despite the welcoming attitude of local officials, led them to make small investments, shut down their ventures and restart them later, or, having reached a certain scale, to shift their profits from reinvestment to the purchase of "extravagant homes or even ancestral tombs" (Whiting 148).

As dramatic as they were, the policy reforms of the late 1970s and early 1980s would not have resulted in sustained growth if these local officials had not chosen to invest on a massive scale. Oi (1999, 25) reports that township and village governments required collective enterprises to re-invest, on average, 50 percent of retained profits.[15] The question is why, in the absence of formal institutions for the protection of property rights, local officials responded to central government reforms by encouraging high rates of investment rather than higher rates of local (and their own) consumption. The experience of Wenzhou City supports the contention that the credibility of promises not to expropriate was key to investor behavior, even when local officials were supportive of private investment. There is no reason to expect that township officials would have been less leery of expropriation by higher-level officials, absent arrangements that allowed higher-level officials to commit credibly not to treat township officials arbitrarily.

Observers disagree about how the central government was able to offer sufficiently credible guarantees to local officials to elicit massive investment. Che and Qian (1998a, b) argue that to induce investment, the central government allowed local governments to operate TVEs and implemented fiscal reforms in 1980 that allowed local governments to keep all revenues above a pre-set amount. This gave them a full claim on all TVE profits above that amount, but also required them to provide local public goods, a reform described as "eating in separate kitchens"

[15] Some fraction of this investment was not productive. For example, some of it likely went to construct new housing for workers (Nee 1992, 24). In addition, there is uncertainty about whether TVEs reinvested or simply had easy access to state bank loans. In either case, rapid output growth is indicative of significant productive investment rather than diversion to immediate consumption.

(*fenzao chifan*) (Whiting 2001, p. 76). Decentralization worked, Che and Qian argue, because local and central governments had similar incentives with regard to the provision of local public goods, such as local roads, but particularly the maintenance of order. As a consequence, the central government had no incentive to expropriate TVE profits. This same strategy could not be replicated by private enterprises, who could not solve the collective action problems needed to provide those same local public goods.

There are two reasons to consider additional explanations, however. First, the revenue reforms had disastrous effects on revenue flows to the central government (see Wong 1992) and were reversed in 1994, though investment continued. Second, the 1980s and especially the 1990s actually saw significant conflict between local and central governments regarding local public good provision. If the governments' interests were aligned with respect to public good spending, the central government would not have needed to specify promotion and bonus criteria that required local officials to provide them. Even in the early 1980s, though, these agreements emphasized the provision of education and the maintenance of social order.[16] In the 1990s, local and central government interests have more clearly come into conflict. For example, local officials have *increased* social disorder by selling off collectively-owned land without fully compensating farmers for their usufruct rights or allow local firms to ignore environmental restrictions.

Intra-party Institutions and Credible Commitments to Investors in the 1980s

An alternative explanation of the willingness of cadres to invest starting in the 1980s places greater weight on the institutionalization of the Chinese Communist Party—checks and balances at the top and the introduction of expensive and more transparent promotion and evaluation systems. Institutionalization began when Deng Xiaoping came to power in 1977. His challenge was to increase the broad popularity of the Communist Party, through broad-based economic development that benefited all Chinese, while at the same time ensuring that party cadres would have privileged access to these benefits to maintain their loyalty and commitment to the CCP. The key to each of these goals was to increase the confidence of cadres that they would be rewarded by the Party if their current decisions led to future economic growth.

On the policy side, therefore, the 1980s reforms assigned local officials many of the rents from reform. These included favorable tax and other rules governing collective enterprises—township and village enterprises, generally administered directly or indirectly by local cadres. The central government also adopted fiscal reforms that made local governments the residual claimants of industrial production and also increased their share of total revenues. The emphasis on TVEs also preserved a source of rents that some cadres had already been receiving. Mao had established some TVEs beginning in 1970 (Byrd and Gelb 4). Though they operated under entirely different rules, local cadres nevertheless secured significant rents from them, partly in their ability to distribute jobs and other resources (Oi, 1989), which would have fallen if the government had not given them privileged access to capital and low taxes relative to private sector competitors.

These policies also softened ideological opposition to the move away from Soviet-style central planning. Although many cadres were doubtless involved in market activities, other cadres

[16] This concern is similar to central government actions in the context of macroeconomic policy, where the conflict of interest between local and central government officials was clearer. Huang (1996) argues that the central government used the career concerns of local officials to prevent them from adopting expansionary strategies (that is, with regard to bank credits), imposing inflationary externalities on the rest of the country.

were strongly opposed to private enterprise. Oi (1999, p. 74), for example, quotes rural officials in one county who in the 1980s referred to private entrepreneurs as underground snakes (*ditou she*). Party leaders would have ignored ideological opposition at their peril. As the splits in the Congress Party in India demonstrates, ideological opposition is a prelude to political opposition. Greater external opposition to the party, in turn, would have reduced the value of future commitments to cadres.

The policy reforms to encourage cadre economic activity depended on the credibility of the incentive system set up by the party leadership. To address this core governance issue, in 1980 Deng began to introduce "a system governed by rules, clear lines of authority, and collective decision-making institutions to replace the over-concentration of power and patriarchal rule that had characterized China under Mao" (Shirk, p. 9). At their heart, Deng's reforms aimed at increasing the predictability of cadre compensation and advancement. This was key since, as Huang (2003, 127) notes, township enterprises were run by government officials with formal civil service status. Deng immediately began to revamp cadre evaluation to make it more systematic (Whiting 2006 p. 3). By 1983, the Organization Department had implemented concrete and tangible criteria in cadre evaluations, ranging from gross output and investment in the early years to finer measures of economic growth and social stability in the 1990s. The party also created more room at the top in order to reward cadres by instituting mandatory retirement for party cadres (Manion 1992).

Promotion criteria change with the priorities of the central government and as the government attempts to tamp down incentive-driven distortions in cadre behavior. However, the criteria announced in any given year have been respected for that year (Whiting 2006, p. 7). Between 1978 and 1995, Li and Zhou (forthcoming) find that the likelihood of promotion of provincial leaders increases with a province's economic performance and the likelihood of termination decreases.

These rules constituted a significant break from the Mao era. Nevertheless, they were not invulnerable to reversal. A number of conditions raised the costs to the central government of abandoning these reforms, however. First, they were expensive to implement, involving re-training of thousands of cadres and the construction of a costly bureaucratic process for evaluation. This investment was lost to the leadership if it disregarded the newly established rules. Second, Deng Xiaoping was personally credible. He incurred significant personal costs in advocating the same cadre management system under Mao: Mao used the Cultural Revolution not only to dismantle the system, but also to purge Deng himself (Manion 1985, 205). By having paid a high price for his advocacy of systematic cadre management under Mao, he was credible in advocating support for the system when he came to power in 1978.

Third, the plan passed through a series of intra-party checks and balances, the most important of which was the core group of senior leaders. With the death of Mao, authority was spread to a greater extent among the top leadership of the party. Deng Xiaoping, for example, deferred to party elders. Leadership succession at least loosely followed formal rules, but was also clearly a shared decision of thirty or more leaders (Shirk, pp. 71–74).[17] Shirk further points out that policy movement in the 1980s was slowed by lack of consensus among leaders at the top (p. 116–128). While this made reform more difficult, it also made it more difficult to overturn. In the context of personnel reform, the difficult decision to eliminate lifetime tenure for all cadres, numbering almost 20 million was agreed by the top leadership only after significant compromise

[17] A prominent example of looseness: although the collective consent of numerous top leaders was essential to oust Hu Yaobang as general secretary of the CCP in 1987, the leadership chose to ignore the formally required procedure of seeking the ratification of the Central Committee (Shirk, pp. 71–74).

to satisfy the interests of multiple leaders (Manion 1992, p. 11). These same checks and balances impeded unilateral changes to the rules for cadre promotion or the disregard of promotion criteria for cadres.

In the 1990s, the development model shifted and investments from non-cadres, especially from foreign investors, substantially increased. Combined TVE and rural private fixed-asset investment dropped steadily as a fraction of total fixed-asset investment, while the share of urban and foreign-invested firms rose to approximately 14 percent of total investment in 2001–2003, compared to less than three percent in the period 1986–1990 (Huang, forthcoming). This shift in strategy raises two questions, considered in the next section: how did governance arrangements of the 1980s change to encourage foreign and non-cadre domestic investment? and how did this change allow the leadership to continue to balance cadre interests with those of citizens more broadly?

Sources of Investment and Good Governance after 1990

The 1980s model of growth that relied heavily on local cadres confronted three difficulties. First, local cadres had strong political and private incentives to maximize revenues and employment, but weaker incentives to maximize profits, encouraging them to take on debt and to build up tax liabilities that were sustainable only as long as growth continued. Economic retrenchment over the period 1988–1990 exposed the weakness of this model. In 1989, approximately 18 percent of TVEs had severe difficulties: the government allowed 800,000 TVEs to close and 2.2 million others to merge with other enterprises or to be restructured (Nee 1992). Although rural-led growth did not grind to a halt, this episode demonstrated that it had limited promise as a source of future dramatic growth.

Government policy towards the financial sector made the shift away from the cadre-led growth model quite clear. Beginning in late 1997 and in response to the East Asian financial crisis, the central government also embarked on a sweeping financial reform that shifted influence over lending decisions away from local governments (see Shih 2004). It closed hundreds of local banks and financial institutions and transferred lending authority within the four major state banks away from local and provincial offices to Beijing: the loan limits that local branches could approve directly dropped significantly; non-performing loan quotas were tightened and more strictly enforced; and loans to SOEs and western China were given priority. Since private firms had never benefited from lending by state banks, the chief losers in this process were collective enterprises, those controlled by local governments.[18]

The second difficulty with the 1980s model was that it starved the center of revenues. Central government revenues fell as a fraction of GDP from 30 percent in 1970 to 23 percent in 1985 to 12.6 percent in 1993 to 10 percent in 1995. This left it with little choice but to modify the fiscal arrangements developed in the 1980s that had left local governments with the lions' share of revenues. Under the new fiscal plan, the central government assigned types of taxes to different jurisdictions and took greater responsibility for collecting its own taxes. Revenues rose to about 20 percent by 2000 (Yang, 70–74).

Finally, local officials proved to be less reliable agents of the party than leaders had hoped. Concerns about the erosion of the central government's authority were widely voiced in the late 1980s and early 1990s (see Nee 1992, p. 6). On the economic front, the most obvious

---

[18] This is not to say that the banking system is free of government influence; on the contrary, as is demonstrated above, and by others, that influence remains strong, but the influence specifically of lower level governments is now weak.

manifestation of this was the establishment of inter-locality trade barriers to protect local firms from outside competition.

At the same time, the Party's need for committed cadres was lower in 1990 relative to 1980. Early in the reform process, party leaders could not be confident that market reforms would deliver the large payoffs to average citizens that they eventually did. Given the risks of failure, it was particularly important to maintain satisfied cadres. This necessity had diminished by 1990, when market-oriented reforms had demonstrated their success. The cost of maintaining cadre loyalty had also risen since party members had better outside opportunities in the 1990s than in the 1980s. "The lure of lucrative career opportunities in the thriving market economy has led many government bureaucrats to seek jobs in local businesses after leaving the government" (Nee and Opper p. 11).

Instead of TVE and cadre-driven investment, the center turned to FDI and, later, to domestic, private investment. In 1991, private firms of all kinds accounted for only 5.7 percent of industrial output value, compared to almost 52.7 percent for all non-state firms, largely TVEs (Huang, p. 110). As table 7.4 demonstrates, by mid-2003, TVEs (collectives) accounted for a small fraction of sales and profits, a share that continued to fall rapidly, dropping by almost half in mid-2005. Foreign and domestic-financed private firms were the source of the lion's share of manufacturing sales.

Table 7.4 Increasing Role of Domestic Private Investment in China's Manufacturers
percent

	Mid-2003			Mid-2005		
	Sales	**Profits**	**Fixed assets**	**Sales**	**Profits**	**Fixed assets**
State-owned	44	51	65	37	49	58
Collective (TVEs)	*7*	*6*	*4*	*4*	*4*	*2*
Private, foreign-invested	29	32	21	31	28	23
Private, domestic	20	11	10	28	19	17

Source: World Bank, China Quarterly Update, November 2005, table 2.

FDI increased from 0.9 percent of fixed asset investment in all firms in 1983 to 15 percent in 1997. Relative to all non-state firms (TVEs, essentially), FDI was 2.6 percent of fixed investment in 1983 and 31.7 percent in 1997. Huang (2003) attributes the upswing in FDI to the favorable treatment given to foreign investors and to significant disadvantages that had been imposed on domestic private firms, including financial system regulations that were biased against all private enterprises, but which foreign capital was better able to circumvent; a less favorable legal framework confronting domestic investors; and the government preference to sell SOE assets to foreign rather than domestic private investors (Huang 2003, p. 82). For example, until the mid-1990s, domestic private firms were obligated to register as collective firms, formally placing them under control of local governments and exposing them to opportunistic behavior by these governments (Huang 2003, p. 112).

Domestic private investment was slower to rise and was more vulnerable than foreign investment to political turmoil. For example, FDI rose from $3.2 billion in 1988 to $3.4 billion in 1989 and of 812 garment foreign-invested entities created between 1980 and 1990, 521 were established in 1989 and 1990. The total number of domestic private businesses actually fell in 1989 and 1990, however (Huang 2003, p. 201). This is certainly related to the concern on the part of the Party leadership that domestic, though not foreign, domestic enterprises might finance or otherwise ally themselves with an organized opposition to the CCP.

Nevertheless, in 1992, the environment for domestic private enterprises also began to change, when Deng Xioaping called for more private firms. In 1998 the central bank relaxed lending quotas that had severely disfavored private firms and the government finally allowed these firms to export. By 1999, the private sector was recognized in the Chinese Constitution as an integral part of the Chinese economy and put on equal footing with other firms (foreign-invested enterprises had enjoyed constitutional recognition since the 1982 Constitution, Huang 2003, 123). Finally, in July 2001, Jiang Zemin announced that private entrepreneurs should be allowed to join the ranks of the Communist Party (Huang 2003, 130–31). Foreign direct investment began to fall in 1996 in favor of contractual (non-equity) capital inflows and domestic private investment. The ratio of foreign-financed to private fixed investment fell from 48 percent in 1996 to 29 percent in 2000 (Huang 2003, p. 84).

As before, the key question is, why did investors respond to these policy changes? The intra-party checks and balances and the cadre evaluation system that protected local officials from arbitrary treatment by the party in the 1980s would not seem to offer similar protection to foreign investors in the 1990s. Recalling the evidence in Fan, et al. (2006), the size of the Chinese market might alone have attracted huge amounts of private capital once prohibitions on investment were eased. However, governance changes, and particularly the strengthening of institutional checks and balances, also seem to have played a significant role.

At the central government level, intra-elite competition continued to experience increasing regularization through the 1980s and 1990s. Under Mao, intra-elite struggles sometimes ended violently. This was less the case under Deng Xiaoping and even less so after Deng, when the penalties associated with losing a leadership contest have fallen further and are no longer as dramatic as arrest or worse. The growing institutionalization of intra-CCP political checks and balances increases the difficulties confronting any single party leader seeking to act opportunistically.

Other changes are more incipient. For example, local and national people's congresses have exercised increased influence over lawmaking, appointment ratification, budget and policy reviews, and the monitoring and supervision of the behavior of agencies and officials (Whiting 2006 p. 7). Local congresses cannot veto the wishes of local cadres, for example. Still, there are indications of their increased importance. The Standing Committee of the National People's Congress is now a desirable career destination. In 2003, "19 individuals in the prime of their career paths were elected to the NPC Standing Committee" (Yang, 288). The number of provincial party secretaries who chair provincial people's congresses has also risen, from 13 of the 31 in 1998 to 23 out of 31 in 2003 (Yang, 288). Public input was sought into the performance evaluations of local officials (Yang 177). This input had the potential to trigger penalties ranging from loss of bonus to termination.

The government also increased its prosecution of local corruption, targeting especially senior cadres in provincial, prefecture, and county governments. The share of party members disciplined who were senior cadres was three times higher in 2000 as in 1993 (Wedeman 913). Every year between 1995 and 2000, between four and six thousand senior cadres at the provincial, prefectorial and county levels were punished by the DIC (disciplinary inspection committee) system (Wedeman, p. 910). Economic offenses, including corruption, were 22 percent of cases filed by provincial DICs in 1987, but 48 percent in 1997; major cases—those involving more than 10,000 yuan—increased from six percent to over 30 percent in 2000 (Wedeman p. 907). Of those subject to disciplinary action, 25 percent were expelled from the Party, 69 percent were subjected to milder party sanctions, and six percent were referred to the judiciary (Wedeman p. 908).

Increasing political checks and balances have provided a credible underpinning for continuing administrative and judicial reforms throughout the 1990s. Under the auspices of the

Administrative Litigation Law of 1989, 9,934 cases were filed against government agencies in 1989; this rose to 98,000 by 1998. Of the 460,000 total cases over the period, plaintiffs won 35 percent of the time (Yang p. 306). Clarke, Murrell and Whiting (2006) point to the growing institutionalization of legal dispute resolution, replacing the administrative, cadre-centered resolution of disputes that would have favored TVEs. Administrative reforms culminated in 2005 with the passage of a comprehensive legal code governing the civil service, consolidating the regulatory effort to modernize China's state bureaucracy (Nee and Opper p. 9).

These efforts were all aimed, at least in part, at creating a safe climate for investment. As Yang writes, "For Deng Xiaoping, political stability, particularly the continuity of communist Party leadership, was a necessary condition for further economic reforms. Deng clearly recognized that the promotion of economic development through further economic reforms would be essential if the ruling elite were to regain the sort of performance legitimacy it had acquired in the 1980s" (Yang p. 6).

Finally, the Chinese government has used its enhanced fiscal position to directly increase investor rates of return, using massive infrastructure investment—investments that precisely expanded the size of markets, magnifying one of China's principal advantages. From 1990 to 1995, for example, China increased its total road network by 23 percent, and by 50 percent in 2002 (*World Development Indicators*). This attracted private investment for two reasons. First, although most observers agree that much public investment in China has low returns, in part because it is targeted ahead of demand to poor areas of the country, high-return productive infrastructure has nevertheless increased dramatically. Chinese ports, for example, are world class, raising rates of return to private investment in the production of tradables. Second, productive public investments constitute a bond that the government has put up: they have a high political payoff only if private investors take advantage of the new infrastructure. If the government acts opportunistically, investors depart and the investment in infrastructure is lost, just as the earlier investments in cadre evaluation systems would have been lost if the government returned to opaque criteria for cadre advancement.

Governance Stress in the 1990s in China

While the significant adjustments of the 1990s demonstrate the adaptability of the Chinese leadership to shifting political and economic challenges, the new bargain between party leaders and cadres has not been an easy one to sustain. The 1990s adjustments—the decline of TVEs, falling access to capital, and reduced tax shares—moved substantial rents and authority away from local officials. They increased the relative benefits to cadres of pursuing privately beneficial actions that impose costs on society, and specifically on the Party. Corruption, land grabs, and a lack of vigilance with regard to local public good provision (education, environmental safety, etc.) are all possible activities that unmotivated cadres might pursue. There is some evidence that the institutional checks and balances that have strengthened at the top have not offset the weaker incentives to pursue good governance at the local level.

To the extent that governance has weakened at the local level, we would expect to see some citizen reaction. Huang (forthcoming) reports that between 1993 and 1997, the total number of demonstrations rose from 8,700 to 32,000. Officially reported incidents of social unrest rose from 58,000 in 2003 to 74,000 in 2004. These seem directly tied to efforts by local officials to increase their rents, including the transfer of land away from farmers to industrial and other uses and weak oversight of the environmental degradation caused by local enterprises. Results of a survey

conducted by Anthony Saich of Harvard, show that over the period 2002–2005, support for the central government has remained "extremely high"; this is not the case for local governments.[19] "Amid rising unemployment, the righteous discontent with corruption increasingly became a major factor motivating social protests. The political elite clearly felt the heat. According to a 1998 survey of prefecture-level officials attending the Central Party School, 65 percent of the 121 officials believed curbing corruption was the key to winning public confidence" (Yang, 221). Jiang Zemin, in his report to the 16th National Congress, November 2002 insisted, "If we do not crack down on corruption, the flesh-and-blood ties between the party and the people will suffer a lot and the party will be in danger of losing its ruling position, or possibly heading for self-destruction" (Yang, 257).

In addition, governance indicators and the individual experience of private businesses point to the continued prevalence of arbitrary government decision making and corruption. These factors have distorted entrepreneurial decision making. Huang (2003), for example, demonstrates that foreign investors are reluctant to make large single investments in China, consistent with aversion to political risk. For example, in 1999, the biggest private firm in China was the Hope Group, an agribusiness firm, with $600 million in sales in 1999. In 1995, the Tata Group, India's largest firm, had sales of $7.2 billion (Huang 112). More systematically, Singaporean firms made average investments of $1.9 million in China, but $4.8 million elsewhere (Huang 33).

In principle, the leadership should be able to clamp down on corruption and non-performance by local cadres. It does not have a free hand here, however. Cadre loyalty rests on the transparency with which cadres are evaluated. Transparency is easier to sustain when the goals are few and easily documented. When they are many and hard to measure, as is the case in battling corruption, the aggressive prosecution of corruption creates a risk for leadership of being perceived by cadres as arbitrary. For example, the leadership still places significant weight on economic growth and job creation. While social peace and environmental improvement also enter into cadre evaluation schemes, economic growth is the most important. The government cannot easily punish the cadres who succeed with respect to growth, but who are less successful on other margins, without undermining the clarity to all cadres of its promotion criteria processes. As a consequence, anticorruption crackdowns have been sporadic, incomplete and sometimes politically motivated (Yang 220).

The costs of an ill-fought campaign against corruption—of alienating cadres—are significant. Connections to local cadres still provide security for private investors, which would be lost if the credibility of leadership promises to cadres were to fall. Local cadres collect taxes, are responsible for law and order, and conduct other indispensable and hard to monitor tasks for the center. In addition, some of the troublesome rents earned by cadres bind them more closely to the party: cadres can earn these only if the party remains in power and only if they remain in the party.

To offset increased governance problems at the local level, the party has strengthened institutions to oversee local officials and offered expanded avenues of redress. These all work from the top-down and maintain firmly in leadership hands control over cadre careers. They are also more accessible to individuals with more resources and a bigger stake in the outcome: it is costly to pursue legal appeals, to travel to Beijing, to gain access to the right officials. Bottom-up institutions for the evaluation of local cadres, particularly local elections, have been adopted more tentatively. These have the advantage of vesting in the hands of better-informed citizens the responsibility for sanctioning cadre malfeasance. They have the severe disadvantage of detaching cadre career advancement from the decisions of the top party leadership, however.

[19] Reported in *The Economist,* March 25, 2006, p. 15.

Regardless of the specific evolution of governance in the 1990s in China, China is noteworthy for having strengthened institutions in order to improve governance and support broad-based growth. This distinguishes China from other countries without competitive elections, where reliance on cronyism has been more marked.

For example, Mexico under Porfirio Díaz managed to use crony relationships (personal relationships between entrepreneurs and political leaders) to generate investment and growth. Díaz cabinet ministers, family members and close allies were prominent board members of nearly all major enterprises in Mexico at the time (Haber, et al. 2003). State governors in Mexico were similarly vertically integrated into the economic activities of their states. Crony companies typically benefited from generous state policies that would assure them higher rates of return than could be earned by average citizens or investors. High rents in turn cemented their support for the regime. These strategies were sufficient to trigger a marked increase in economic progress (federal revenues grew by 5 percent/year from 1895–1911; per capita GDP rose from moribund levels to 2.2 percent/year over the period 1900–1910) (Haber, et al. p. 51). However, the concentration of economic activity and the concentration of rewards among Díaz cronies became a target for revolt, ultimately culminating in the Mexican Revolution.

What Does the Future Hold?

The experiences of China and India in the 1980s and 1990s underline the importance of restraints on arbitrary government decision making as a precondition for growth. While superb governance is obviously not essential for rapid growth, particularly among poor countries with large markets, both of these countries only started to grow after they had improved the governance environment from quite low levels. Although governance outcomes in both countries have been largely average, another important lesson is how difficult and nuanced must be government efforts to achieve even this. China has reached a delicate balance between satisfying party members and the population as a whole, and between competing leaders at the top of the party, that has eluded leaders in other countries. Governance in India has advanced despite the shadow of clientelist politics that diminish political incentives to maintain it.

China has gone beyond cronyism to use impersonal mechanisms that offer a broader cross-section of economic actors insulation from opportunistic behavior. These mechanisms reside in intra-party institutions of the Communist Party, which improve the governance environment at least for those who are party members. Institutionalized parties offer a way for leaders to make credible promises to large numbers of party members that, for example, they will not be expropriated if they invest; that promotion criteria for good performance (that is, encouraging broad-based growth in the jurisdictions for which they are responsible) will be respected; and that, more generally, party members will not be sidelined for arbitrary reasons (for example, related to internecine struggles for control).

The credibility devices adopted by the CCP required leaders to share rents widely across a large body of cadres and to accept a policy of obligatory retirement. In many countries, the rents that leaders would lose from sharing are greater than those they gain by boosting economic growth from enhanced credibility. In countries with significant natural resource rents, for example, which require little participation by most of society to extract, the rents lost by leaders exceed what they gain from power-sharing.

The Chinese government's continued success in balancing popular and cadre demands has been key to achieving average governance outcomes. As wages rise and extraordinary profits from large markets fall, still better governance will be key to continued fast growth. This will

require that the leadership succeed in advancing still further its agenda of institutionalizing intra-party constraints on opportunism by government officials. This is not an easy prescription.

As long as the Party requires committed cadres, it needs to provide them with exceptional rewards, above and beyond what they can achieve outside of the Party. Currently, those rewards come from the satisfaction of serving the public, from the promise of promotion, and from their direct exploitation of economic opportunities. In Singapore, this commitment is provided by very high public sector wages, combined with equally high performance standards. To the extent that greater institutionalization requires a more aggressive crackdowns on corruption or the subordination of local cadres to local courts of peoples' congresses, such increased compensation may be needed to maintain cadre loyalty.

The stability of the cadre-leadership bargain rests as well on the entrenchment of the party. If the government experiences severe popularity shocks, or if social unrest increases more rapidly than the government can move in renegotiating the cadre-leadership contract in order to improve local governance, the price of cadre loyalty will rise, making governance more difficult to improve. China's cautious approach to major macroeconomic policy changes, such as financial sector reform or exchange rate flotation, underlines its sensitivity to popularity shocks, such as those precipitated by adverse economic events or unexpected citizen dismay at particular aspects of government policy. The experience of 1989 demonstrates, as well, that reactions to popularity shocks have been directed at the domestic private sector: following the events of 1989, the official attitude towards private entrepreneurs deteriorated dramatically (Huang 2003). To the extent that growth is more dependent on private investment, as it is to a much greater extent in China now relative to 1989, such a strategic shift would have more noticeable effects on growth and investment.

India is well-endowed with external institutions of credibility—political checks and balances, for example, that are not dependent on any particular party. These have been sufficient to yield average governance and mean that economic and political shocks are not a particular threat to future growth in India. Instead, the issue for the future is improving governance and policy generally: greater opening of the economy to allow more entry, more innovation and wider participation across all markets. Electorally, this agenda has not been easy to sell. Cleavage-riven social settings, lack of education, isolation and poverty itself conspire to make voters responsive primarily to clientelist promises and easily observed subsidies.

However, India has also embarked on a vast program of decentralization, instituting local elections and putting greater revenue and public service responsibilities in the hands of local governments. It has aggressively experimented with institutions to bring the disadvantaged into politics, including reserved seats for women and lower casts on local government councils. These new local governments hold the promise of overcoming some of the obstacles to improved governance, for example by removing some of the information barriers that make electoral accountability difficult to generate at higher levels of government.

Finally, though, India and China provide hopeful signs of a virtuous circle, that growth can help to propel governance reforms in countries able to achieve even a moderate level of governance to begin with. In China, growth in the 1980s gave the Communist Party leadership sufficient confidence in the Party's public approval that in the 1990s it risked opening up the economy to private investment and cracking down on excessive rent-seeking by party members. It has allowed the leadership to demand more of cadres than growth, where the benefits have been easy to share between party members and citizens more broadly, to embrace higher quality public services, reduced pollution, and more transparent local land management, where the sharing is more difficult.

In India, Wilkinson (forthcoming) argues, growth seems to be creating a constituency less tolerant of clientelist political appeals, one that favors more far-reaching governance reform and

equity- and growth-promoting policies. As the cost of clientelist strategies (appeals to targeted voters) has risen, political parties in India are evolving to identify themselves with economic policy platforms. This is a slow process—certainly, redistributive appeals continue to be the main currency of political competition in India—but it will be an important factor contributing to continuous governance improvements and growth.

References

Acemoglu Daron, Simon Johnson and James Robinson (2002). "Reversal of Fortune: Geography and Institutions in the Making of the Modern World Income Distribution." *Quarterly Journal of Economics* 117:4, 1231–94 (November).

Acemoglu, Daron and James A. Robinson (2006). *Economic origins of dictatorship and democracy.* New York: Cambridge University Press.

Banerjee, Abhijit, Shawn Cole and Esther Duflo (2003). "Bank Financing in India." Mimeo, MIT Department of Economics.

Beck, Thorsten, George Clarke, Alberto Groff, Philip Keefer, Patrick Walsh (2001). "New Tools in Comparative Political Economy: The Database of Political Institutions." *World Bank Economic Review,* 15:1, 165–176.

Brass, Paul R. (1990). *The Politics of India since Independence.* The New Cambridge History of India, Volume IV.1. Cambridge: Cambridge University Press.

Byrd, William and Alan Gelb (1990). "Township, Village and Private Industry in China's Economic Reform." Policy Research and External Affairs Working Papers, WPS 406 (April).

Cai, Hongin, Hanming Fang, Lixin Colin Xu (2005). "Eat, Drink, Firm, Government: An Investigation of Corruption from Entertainment and Travel Costs of Chinese Firms." NBER Working Paper 11592.

Che, Jiahua and Yingyi Qian (1998a). "Institutional Environment, Community Government, and Corporate Governance: Understanding China's Township-Village Enterprises." *Journal of Law, Economics and Organization* 14:1, 1–23 (April).

————. (1998b). "Insecure Property Rights and Government Ownership of Firms." *Quarterly Journal of Economics* 113:2, 467–96.

Clague, Christopher, Philip Keefer, Stephen Knack and Mancur Olson (1996). "Property and Contract Rights under Democracy and Dictatorship." *The Journal of Economic Growth* 1:2, 243–276 (June).

Clarke, Donald, Peter Murrell and Susan Whiting (2006). "The role of law in China's economic development." Public Law and Legal Theory Working Paper no. 187, George Washington University.

Fan, Joseph, Randall Morck, Lixin Colin Xu, Bernard Yeung (2006). "Does the quality of the government matter in attracting FDI: The China case in a Global Context." Mimeo, New York University.

Frankel, Francine R. (2005). *India's Political Economy, 1947–2004.* New Delhi: Oxford University Press.

Gehlbach, Scott and Philip Keefer (2006). Credible Commitments in Autocracies.

Haber, Stephen, Armando Razo and Noel Maurer (2003). *The Politics of Property Rights: Political Instability, Credible Commitments, and Economic Growth in Mexico, 1876–1929.* Cambridge: Cambridge University Press.

Huang, Yasheng (1995). "Administrative Monitoring in China." *The China Quarterly* 143, 828–843 (September).

————. (1996). *Inflation and Investment Controls in China.* Cambridge: Cambridge University Press.

————. (2003). *Selling China: Foreign Direct Investment during the Reform Era.* New York: Cambridge University Press.

————. (forthcoming). "Just How Capitalist is China?" In the *International Handbook of Development Economics.*

Keefer, Philip and Razvan Vlaicu (2005). "Democracy, Credibility and Clientelism." Policy Research Working Paper 3472, The World Bank.

Keefer, Philip and Stuti Khemani (2005). "Democracy, Public Expenditures, and the Poor: Understanding Political Incentives for Providing Public Services." *The World Bank Research Observer* 20:1 (Spring), 1–28.

Knack, Stephen and Philip Keefer (1995). "Institutions and Economic Performance: Cross-Country Tests Using Alternative Institutional Measures." *Economics and Politics* 7:3, 207–27.

Kochhar, Kalpana, Utsav Kumar, Raghuram Rajan, Arvind Subramanian and Ioannis Tokatlidis (2006). "India's Pattern of Development: What Happened, What Follows." NBER Working Paper 12023, February.

Kohli, Atul (forthcoming). "Politics of Economic Growth in India, 1980–2005." *Economics and Political Weekly.*

Li, Hongbin and Li-An Zhou (forthcoming) . "Political turnover and Economic Performance: The Incentive role of Personnel Control in China." *Journal of Public Economics.*

Malhotra, Inder (2003). *Dynasties of India and Beyond.* New Delhi: Harper Collins.

Manion, Melanie (1992). "The Cadre Management System, Post-Mao: The Appointment, Promotion, Transfer and Removal of Party and State Leaders." *The China Quarterly* 102, 203–33 (June).

————. (1992). "Politics and Policy in Post-Mao Cadre Retirement." *The China Quarterly* 129, 1–25 (March).

Mengistae, Taye, Lixin Colin Xu and Bernard Yeung (2006). "Business Climate and Indian and Chinese Firms." Mimeo.

Nayar, Baldev Raj (1990). *The political economy of India's public sector.* London: Sangam Books.

Nee, Victor (1992). "Organizational Dynamics of Market Transition: Hybrid Forms, Property Rights, and Mixed Economy in China." *Administrative Science Quarterly* 37:1, 1–27 (March).

Nee, Victor, and Sonja Opper (2006). "China's Politicized Capitalism." Background paper for *Dancing with Giants: China, India, and the Global Economy,* ed. L. Alan Winters and

Shahid Yusuf. Washington, DC: World Bank, and Singapore: IPS. http://econ.worldbank.org/dancingwithgiants..

North, Douglass and Barry Weingast 1989. "Constitutions and Commitment: The Evolution of Institutions Governing Public Choice in Seventeenth-Century England." *Journal of Economic History* 49 (December): 803–32.

Oi, Jean Chun (1989). *State and Peasant in Contemporary China: The Political Economy of Village Government.* Berkeley: University of California Press.

————. (1999). *Rural China Takes Off: Institutional Foundations of Economic Growth.* Berkeley: University of California Press.

Qian, Yingyi (2003). "How Reform Worked in China." In *In Search of Prosperity: Analytic Narratives on Economic Growth,* Dani Rodrik, ed, 297–333. Princeton: Princeton University Press.

Quinn, Dennis P. and John Woolley (2001). "Democracy and National Economic Performance: The Preference for Stability." *American Journal of Political Science* 45:3, 634–657.

Rodrik, Dani and Arvind Subramanian (2005). "From Hindu Growth to Productivity Surge: the Mystery of the Indian Growth Transition." *IMF Staff Papers* 52: 2.

Shanker, Kripa and T. G. Nayak (1983). "Shifts in the factor income shares-A comparative study of the public and private Indian corporate sector, 1960–61 to 1977–78." Occasional Papers, Reserve Bank of India 4:82–109 (June).

Shih, Victor (2004). "Dealing with non-performing loans: Political Constraints and Financial Policies in China." *The China Quarterly* 922–944.

Shirk, Susan L. (1993). *The Political Logic of Economic Reform in China.* Berkeley: University of California Press.

Stasavage, David 2003 *Public Debt and the Birth of the Democratic State: France and Great Britain 1688–1789.* New York: Cambridge University Press.

Wedeman, Andrew (2004). "The Intensification of Corruption in China." *The China Quarterly* 895–921.

Whiting, Susan H. (2001). *Power and Wealth in Rural China: The Political Economy of Institutional Change.* New York: Cambridge University Press.

Wilkinson, Steven I. (forthcoming). "Patterns of Party-Voter Linkages in India." Chapter 5, Wilkinson and Kitschelt eds., *Clientelism* XX.

————. (2006). "The Political Incentives for Infrastructure Provision in India." Mimeo.

Wong, Christine P. W. (1992). "Fiscal Reform and Local Industrialization: The Problematic Sequencing of Reform in Post-Mao China." *Modern China* 18:2, 197–227 (April).

Yang, Dali L. (2004). *Remaking the Chinese Leviathan: Market Transition and the Politics of Governance in China.* Stanford: Stanford University Press.