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Rural Nonfarm Development in China and India: The Role of Policies and Institutions

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ABSTRACT

The dynamic rural nonfarm sector in China has been a major contributor to the country's remarkable growth, while in India the growth in output and employment in this sector has been rather stagnant. The paper argues that the observed patterns in the rural nonfarm development are the results of institutional differences between the two countries, especially in their political systems, ownership structure, and credit institutions. A review of the strengths and weaknesses of the rural nonfarm economy in China and India highlights the potentials and challenges of growth in the sector.

RURAL NONFRAM DEVELOPMENT IN CHINA AND INDIA: THE ROLE OF POLICES AND INSTITUTIONS

Anit Mukherjee and Xiaobo Zhang[1]

I. INTRODUCTION

China and India together constitute more than one-third of the world's population. At the beginning of the 1950s, both China and India were mainly rural, low-income economies, with agriculture as the predominant sector of the economy. Over the last five decades, China and India have made dramatic improvements in their standard of living, structural transformation of the economy and development of the secondary and tertiary sectors. Agricultural growth has made both countries self-sufficient in food, providing a residual surplus for export and capital for other sectors. The rural sector, as a result, has undergone substantial changes in composition. Industries and services now form an integral part of the output and employment of the rural sector. The share of agriculture in total GDP has declined to less than one-third in India and less than one-fifth in China. This transition is remarkable considering the initial situation in the two countries half a century ago.

The rural nonfarm sector has played a key role in the economic transition of both countries over the past two decades. A look behind the macro-economic aggregates reveals more rapid growth of rural nonfarm employment in China than in India, especially over the decade of the 1990s. After the initiation of the open-door policy in China, the dynamic rural nonfarm sector has been a major contributor to the country's remarkable export growth in recent years. Rural township and village enterprises (TVEs), and more recently private enterprises (PEs), have generated large amounts of

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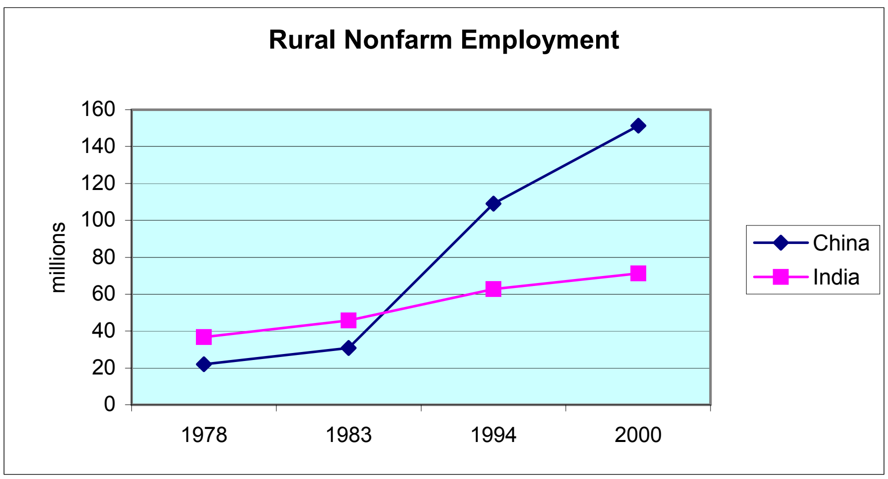
employment for the rural labor force and have absorbed the labor released from agriculture.

In India too, the small-scale sector, including traditional village industries, contributes nearly two-thirds of organized sector employment. After a period of sustained expansion in the 1980s, however, growth in output and employment in this sector has fallen significantly. During the 1990's, when China's rural manufacturing sector was thriving, India witnessed a decline in the share of rural nonfarm manufacturing in national GDP. Compared to China, rural nonfarm employment has increased only moderately (Figures 1 and 2).[2]

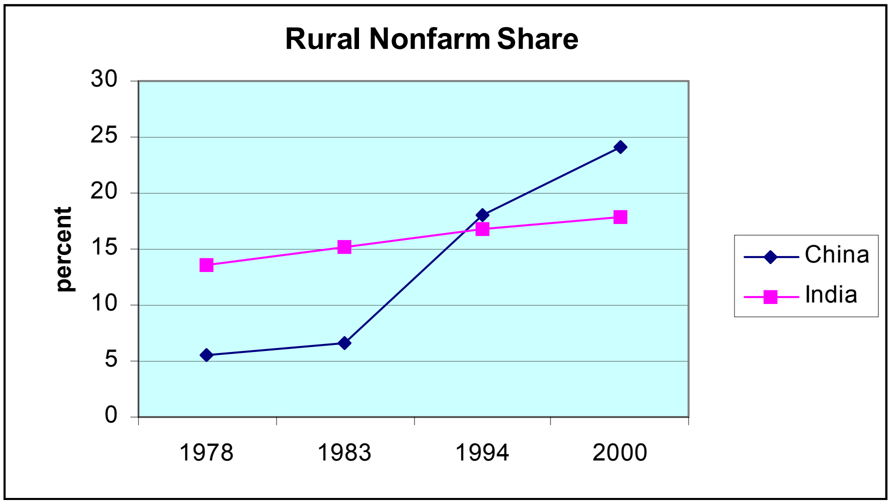
Figure 1. Rural Nonfarm Employment, 1978-2000



Source: *India - National Sample Survey Organization, Various Years; China - Fan, Robinson and Zhang (2003).*

[2] As in any comparative exercise, data comparability poses a challenge. Definitions of "rural" as well as coverage of "nonfarm" activities both merit attention. India defines rural areas as all localities with population below 5,000, population density below 400 persons per square kilometer and at least 75 per cent of the male working population engaged in agriculture. In China, the household registration system known as *hukou* has generally been used to demarcate rural and urban areas. Although many rural localities in China have grown into small towns over the last half a century, they remain classified as "rural." Thus, the less rapid growth in "rural" nonfarm employment in India may stem, in part, from the automatic reclassification of rural areas as "urban" as the nonfarm economy goes. For rural enterprises in India, the Annual Survey of Industries (ASI) provides data for manufacturing units only, but National Sample Survey (NSS) on employment and National Accounts Statistics (NAS) include all types of rural establishments, both in industry as well as in commerce and services. Statistics on rural enterprises in China include all enterprises at or below the township level. Apart from manufacturing, the data includes enterprises engaged in transportation, commerce, construction and food services. These caveats have to be kept in mind while analyzing the rural nonfarm sector in the two countries.

Figure 2. Rural Nonfarm Share in Total Employment, 1978-2000



Source: *India - National Sample Survey Organization, Various Years; China - Fan, Robinson and Zhang (2003).*

This paper examines why development of the rural nonfarm sector has followed different paths in China and India over the past two decades and whether this can help us better understand differences in the overall performance of the two countries. Can the differences be explained by the evolution of policy-making directed at the rural nonfarm sector over the period leading up to the late-1970s? How much of the current growth or stagnation are the results of institutional differences between the two countries, especially in their political systems, ownership structure, credit institutions and macro-economic policies? What lessons can be learned from the relative strengths and weaknesses of the rural nonfarm sector in the two countries? Lal (1995) compares the economic liberalization in China and India up to 1990. However, because most India's liberalization policies did not fully start until the early 1990s, it is necessary to extend his comparison to a later period. This paper tries to fill the gap with a particular focus on the rural nonfarm sector.

These questions hold implications for smaller developing countries as well. Ongoing globalization and structural adjustment policies have played a key role in driving recent changes in rural nonfarm economies across the developing world. With China and India joining the World Trade Organization (WTO), these two large and growing economies exert an increasing impact on world markets for goods as well as services. An examination of the causes, potentials, strengths, and weaknesses in China and India should, therefore, provide useful indications for other developing countries in the process of nurturing a viable rural nonfarm sector in the current global context.

II. POLICY FRAMEWORK FOR NONFARM DEVELOPMENT

To understand the context of rural nonfarm sector development, it is necessary to look at the path of policy-making since independence in India and China. In this section, we focus on those aspects of policy decisions that have had the most significant impact on the rural nonfarm sector.

Common Threads

Agriculture. Rural development policy in both India and China has focused on agriculture, in policy formulation, allocation of public investments and recurrent budgets. Beginning earlier in India, these considerable investments in research, infrastructure, rural credit, and price support programs led to the launching of green revolution in rice and wheat production from the second half of the 1960's onwards (Fan, Hazell and Thorat, 1999). In China, rural nonfarm began to take off in the agriculturally advanced regions only after the rapid growth in the agricultural sector form 1978 to 1984. In both countries, agricultural prosperity has fueled rural economic growth, enabling transfers of labor and capital from agriculture to manufacturing and services while ensuring moderation in urban food prices. In many ways, agricultural policy has formed the corner stone of rural nonfarm policy in both countries.

Commerce and services. In the rural nonfarm economy specifically, both India and China have concentrated policy and support programs almost exclusively on manufacturing. Both have largely ignored rural commerce and services. Instead, the bulk of policy attention has focused on rural industry and on related macro-economic policies. In spite of this policy de-emphasis, rural commerce and services have flourished, proving the most buoyant segments of the rural nonfarm economy in both India and China over the past two decades (Tables 1, 2, 3). In India, rural commerce andservices are now roughly twice the size of the manufacturing sector in terms of employment (Table 1).

Table 1. Distribution of Total Employment in India (%), 1978-2000

Industry Division	Rural					Urban				
	1977-78	1983	1987-88	1993-94	1999-2000	1977-78	1983	1987-88	1993-94	1999-2000
Agriculture and Allied Activities	83.4	81.2	78.3	78.4	76.3	15.3	14.6	13.4	12.3	8.6
Mining and Quarrying	0.4	0.5	0.6	0.6	0.5	0.8	1.0	1.2	1.2	0.8
Manufacturing	6.2	6.7	7.2	7.0	7.3	28.0	26.7	26.0	23.6	22.7
Utilities	0.1	0.1	0.2	0.2	0.2	0.8	0.9	1.0	1.0	0.7
Construction	1.3	1.7	3.3	2.4	3.3	3.8	4.7	5.4	6.3	8.0
Wholesale and Retail Trade and Restaurants and Hotels	3.3	3.5	4.0	4.3	5.1	18.8	18.4	19.0	19.4	26.9
Transport, Storage and Communication	0.8	1.1	1.3	1.4	2.1	7.9	8.1	7.8	8.0	8.7
Service	4.4	4.9	5.0	5.7	5.2	24.6	25	25.7	28.2	23.6
Total	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**
Total Employment (Million)	**221.3**	**243.1**	**252.5**	**290.3**	**300.8**	**49.2**	**59.6**	**69.5**	**81.8**	**96**

Source: *National Sample Survey*

Table 2. Distribution of Rural Net Domestic Product (India) – Farm and Nonfarm

Industry Division	Share in Rural NDP		Share of Rural Areas in Total NDP	
	1980-81	1999-00	1980-81	1999-00
Agriculture and Allied Activities	64.36	54.41	94.89	94.04
Manufacturing	9.16	8.13	31.84	29.58
a. Registered	3.15	5.13	20.37	30.05
b. Unregistered	6.01	3.00	45.18	28.81
Utilities	0.56	1.34	40.02	40.37
Construction	4.05	4.99	45.62	39.12
Trade and Restaurants and Hotels	6.68	6.94	30.34	22.82
Transport, Storage and Communication	1.32	4.17	22.99	34.39
Real Estate and Business Services	4.55	3.16	49.88	29.32
Community Social and Personal Services	7.27	12.50	39.08	41.70
Total Rural Nonfarm Sector	**35.64**	**45.59**	**34.97**	**31.64**
Total Net Domestic Product (%)	**100**	**100**	**58.91**	**49.52**

Source*: National Accounts Statistics, Government of India (Adapted from Chadha, 2003*)

Rationale. The rationale in both countries for developing the rural nonfarm sector has been essentially the same: to provide employment to a growing rural population, produce goods and services for local consumption, to reap the comparative advantage in terms of labor-intensive modes of production, and to forge links with large-scale, capital intensive urban industry. Both the countries have had some success in meeting these objectives.

While both countries have maintained a common focus on rural industry, policy specifics have differed in India and China, as the following discussion will reveal.

Table 3. Employment in China's TVEs, 1978-1997

Year	Employment in TVEs		Sectoral share within TVEs (%)				
	Millions	Share of rural labor (%)	Agricul-ture	Indus-try	Construc-tion	Transpor-tation	Commerce & services
1978	28	9	22	61	8	4	5
1980	30	9	15	65	11	4	5
1983	32	9	10	67	15	3	5
1984	52	15	5	70	13	2	9
1990	93	22	3	60	15	8	15
1995	129	29	2	59	15	7	16
1997	131	28	2	47	10	3	38

Note: Data before and after 1984 are not comparable because of changes in statistical coverage.
Source: Huang (1999), taken from Statistical Yearbook of China, and Township and Village Enterprises Yearbook of China, various issues.

Industrial Policy in India

<u>The early independence years</u>

In India, in the decades following World War II, the newly independent central government placed primary investment priority on heavy, urban-based manufacturing. The emphasis after independence was to substitute imported consumer goods by local manufactures. It is interesting to note that the very first Industrial Policy Resolution in post independence India in 1948 mentioned China as a model to be followed in order to organize the cottage and small-scale industries into effective institutions for providing employment opportunities.[3] Under Nehru's leadership, the emphasis of the Industrial

[3] "Cottage and small-scale industries have a very important role in the national economy. Offering as they do scope for individual, village or co-operative enterprise, and means for the rehabilitation of displaced persons…One of the main objectives will be to give a distinctly co-operative bias to this field of industry. During and before the last war, even a predominantly agricultural country like China showed what could be done in this respect and her mobile industrial co-operative units were of outstanding assistance in her struggle against Japan" (Industrial Policy Resolution, Government of India, 1948).

Policy Resolution of 1956 turned to large-scale capital-intensive industries such as steel, petrochemicals, engineering, machinery, etc., under the public sector umbrella. The second Five-Year Plan of 1956 (which came to be known as the Mahalonobis model) set the stage for the development of India's heavy industry.

At the same time, policies reserved special concessions for household and small industry, the village and khadi (handloom) industries, championed by Gandhi and his followers. The 'small-scale' industry was supposed to supply the consumer goods needed by workers in the large-scale sector. The model, therefore, merged Gandhi and Nehru's divergent visions of industrial development in post-independence India (Little, Majumdar and Page, 1987). The Small Scale Industries Board (SSIB) and the Central Small Industries Organization (CSIO) were set up following the recommendation of the Ford Foundation team in 1954. These institutions helped in laying the groundwork for the development of the small-scale manufacturing sector for the next two decades. Through a system of direct licensing, production controls in large manufacturers, differential taxation and direct subsidies, they reserved over 800 items – including handlooms, pottery, match making and sericulture – for rural and small-scale producers (Kashyap, 1988). Direct and indirect subsidy rates reached as high as 70% of factory price (Sandesara, 1980).

With the green revolution in agriculture, farm output and productivity increased in most parts of rural India. There was a growing demand for goods and services produced locally throughout the 1970s. Since there was no barrier to entry, small household enterprises catering to the need of the farm sector flourished in all segments of the nonfarm sector, especially in manufacturing, transport and services. The positive farm-nonfarm linkage theory, corroborated by several empirical studies (Hazell and Haggblade, 1991), was reflected in the government's policy pronouncements, especially the Industrial Policy Resolution of 1980.

The decade of the 1980s was actually the best to date in terms of employment growth. A policy of protection, domestically through licensing of small-scale units and externally through quantitative quotas on imports, coupled with cheap credit, investment subsidy and infrastructure provision was instrumental in bringing about a substantial increase in both employment and output share of the rural nonfarm sector. Rural employment, especially rural nonfarm employment, grew rapidly. Backward linkage from nonfarm employment to agriculture may have sustained the productivity increase in the farm sector during this period (Fan, Hazell and Thorat, 1999; Mukherjee and Kuroda, 2001). More than 45 million jobs were created in the rural areas during the 10-year period 1983 – 93, most of which were in the nonfarm sector (Table 1). However, unlike China there was no large-scale shift in labor shares between the farm and nonfarm sectors.

Reform

A balance of payments crisis at the beginning of the 1990s produced a macro-economic crisis for the Indian economy. In response, in 1991 the government adopted a policy of economic reform, both in the domestic as well as the external sector. The most significant aspect of the domestic reform agenda was the liberalization of the industrial sector. The Industrial Policy Statement of July 1991 abolished licensing (known as the 'license-permit raj') that gave rise to rents and corruption in the industrial sector. Although the sectors of industry reserved for the small-scale sector remained intact, there was a shift from non-tariff barriers to tariff rates that decreased over the 1990s. The Monopolies and Restrictive Trade Practices (MRTP) Act was amended to remove the limit on capital investment. This eliminated the requirement of prior approval of the Central Government for establishment of new undertakings, expansion of undertakings, merger, amalgamation and takeovers within the industrial sector. Policy emphasized exports to earn foreign exchange. All industrial units with export potential were allowed to import capital equipment freely.

The economic reform process adversely affected the small-scale sector, especially rural manufacturing. Growth in small-scale units fell by more than half, from over 9 percent in the period between 1981-1986 to 4.3 percent in 1996 – 2001. Except for exports, similar decreases in growth rates were recorded for output and employment in small-scale manufacturing during the two periods (Bala Subrahmanya, 2004). The share of the rural nonfarm sector in total nonfarm Net Domestic Product (NDP) actually decreased from nearly 35 percent in 1981 to 31.6 percent in 2001. This indicates that a widening gap between secondary and tertiary activity and between rural and urban areas, with serious consequences for both regional as well as rural-urban income distribution (Table 2).

Industrial Policy in China

Pre-reform

Interest in the development of the rural nonfarm sector in China is of a more recent vintage as compared to India. During the 1950s, China's leaders and policymakers were preoccupied with 'catching-up' with the developed world, primarily Japan. They placed overwhelming emphasis on heavy industries, and the relative price of agricultural commodities was kept artificially low to transfer resources from rural to urban areas (Lin and Yao, 1999).

Promotion of rural industry began during Mao's Great Leap Forward in 1958 with the establishment of large numbers of rural iron and steel foundries aimed at serving agriculture and helping rural areas to "walk on two legs" (Ho, 1986). During the 1960's and 1970's, government promotion efforts focused on five small industries – iron and steel, fertilizer production, cement, coal and hydroelectric power plants, and machine building – aimed at providing modern inputs for agriculture (Perkins, 1977; Sigurdson, 1977; Saith, 1980). This rapid, mandated expansion resulted in overdevelopment of heavy rural manufacturing activity (Table 4). Many plants proved to be technically inefficient and economically unviable (Ho, 1986).

Rural nonfarm activity was collectivized during the first five-year plan (1953-1957). Then, in 1958, the Communist Party leadership transformed the rural nonfarm activities into commune-brigade enterprises (CBSs). In China's command economy, these rural enterprises faced severe discrimination in material and equipment allocations as urban manufacturing enterprises received priority. Forced to adapt to these shortages, the rural CBS endured the sting of periodic criticism as 'the tails of capitalism' (Ho, 1986). Major reforms since the late 1970s enhanced priority for CBE's by providing tax concessions to qualified enterprises and instructions that urban industries farm out production to CBS wherever possible. The dismantling of the commune system in 1984 led to the development of TVEs and private enterprises as described below.

Table 4. Composition of Rural Nonfarm Employment in China, 1981

Nonfarm activities	Employment Share
Manufacturing	45%
Construction	9%
Commerce and commercial services	12%
Transport and communication	5%
Services (including government)	28%
Total	**100%**

Source: Ho (1986).

Post-reform

After a decade of social and economic turmoil between 1966 to 1976, China's economic reforms started in earnest under Deng Xioping from 1978 onwards. The commune system was abolished and the household responsibility system (HRS) came into force. The former commune and brigade enterprises that operated under the old system of rural collective enterprises were renamed 'township and village enterprises' or TVEs. Agricultural productivity increased dramatically between 1978 and 1985, and the TVE sector flourished concurrently (Fan, Zhang, and Robinson, 2003).

From the early 1980s, therefore, there is evidence of structural change in the Chinese economy (Fan, Zhang and Robinson, 2003). The most significant aspect of this transformation is undoubtedly the development of the rural nonfarm sector. From being inconsequential in the late 1970s, the rural nonfarm sector, especially rural industries, has matured over the last three decades. Considering its growing importance in employment, output and export, China's rural nonfarm sector is the main source of the high rates of economic growth in the recent past.[4]

Rural industrialization in China after the start of reforms in the late 1970s can be divided into four distinct periods (Lin and Yao, 1999). In the first phase from 1978 to 1984, rural industrial growth was overshadowed by the unparalleled performance of agriculture which largely benefited from the rural reform. By 1984, the TVEs produced nearly 16 percent of total industrial output compared to 9 percent in 1978. Its share in gross total rural output increased from 24 percent to 33 percent over the period and its share in rural labor significantly increased from 9 percent to 14.5 percent.

The second period from 1984 to 1988 was marked by an acceleration in the rate of growth of output and employment in the rural nonfarm sector in China. This period also coincided with more stable institutional arrangements in ownership and use of revenue generated in the TVEs. Local governments took the lead in utilizing the capital accumulated during the previous phase of agricultural growth to set up rural industrial units catering to increased local demand. There was a three-fold increase in the number of rural enterprises from 6 million in 1984 to more than 18 million in 1988. The nonfarm share in total rural labor increased from 14.5 percent to nearly 24 percent, while the share in gross rural output increased by more than 20 percent from its 1984 level. The stage was set for the structural transformation in the Chinese economy led by the rural nonfarm sector.

The third period, from 1989 to 1991, was marked by a backlash from the government against the rural TVEs. It is the only phase in the history of China's nonfarm growth when the number, employment and share of output of the sector all declined. However, unlike India's current predicament, this phase did not last long, and the political leadership under Deng Xioping came out in full support of the policy of continuing reform and openness in a famous 1992 visit to Guangdong. The opening up of

[4] The rural sector is mainly defined by the household registration system.

the economy provided the TVE sector a broader space to compete both domestically and internationally.

This clearing of ideological and political confusion has contributed to the current phase of expansion of the TVE sector. By 1997, the rural TVE sector was employing nearly 30 percent of the rural labor force, producing nearly 80 percent of the gross rural output and nearly two-thirds of total industrial output. Coupled with increased growth of rural ‘private enterprises’ (PE) and the tertiary sector, there is higher participation of private capital in the development of rural nonfarm sector. By the end of the 1990s, China had privatized most of its TVEs.

III. THE ROLE OF INSTITUTIONS

Institutional developments and relationships translate government intentions, explicit or implicit, into action. Institutional relationships and governance have evolved significantly in both countries over the past few decades, and in so doing they have influenced the current levels of dynamism in the rural nonfarm sector in China and India.

The impact of institutions and governance needs to be analyzed from several vantage points. Firstly, the differences in political economy have to be explained in order to appreciate the *process* of policy formulation, especially with regard to the rural nonfarm sector. These differences translate into specific policies regarding the role of the state and private actors vis-à-vis the ownership structure, the creation of an enabling environment for the nonfarm sector (such as markets, infrastructure and other public goods), the incentives for promoting the rural nonfarm sector, as well as sustaining and expanding it. The *outcome* of a particular set of policies can be seen both from the rates of growth of the sector as a whole, and also from the spatial differences in growth patterns. Flexible institutions and responsive governance can correct for structural imbalances, and also eliminate differences between sectors and regions. Therefore, the strengths and weaknesses of the rural nonfarm sector in China and India may also be thought of as an outcome of institutional development in the two countries reflecting economic priorities and political environments.

Initial Endowments: Diverging Political and Economic Systems

Comparisons of economic development between China and India dwell for the most part on the differences in political institutions and organization of the economy (Lal, 1995). It is true that this serves as a good first step towards analyzing the different paths that the two economies have taken over the last fifty years. Our present mandate is to extend this analysis to assess their impact on the overall progress of the rural nonfarm sector. This would be our contribution to understand better the similarities and contrasts between the rural nonfarm sectors in the two countries.

Policymaking in China is generally regarded as top-down, with the party hierarchy carrying out orders of the top leadership. The resulting strong organizational capital can be an asset in overcoming common coordination failure problems, if used correctly. In addition, China is a rather homogenous society, lowering the social cost to deal with conflict. In contrast, formation of policy in India is thought to be generally slower, as the democratic structure and various interest groups have to be taken on board before any radical shift in policy direction.

Most studies on the differences in development between India and China have concentrated on democracy versus dictatorship or private initiative versus state-led development paradigms. In the case of the rural nonfarm sector, there is a tendency towards convergence in policy between the two countries. There are several points of similarity, as well as of contrast. From the point of view of the initial political and economic endowment, however, the differences can be summarized in terms of the ability of the two countries for collective action and to manage conflicts, both economic and political (Bardhan, 2003).

A democratic structure is thought to restrict the opportunity for collective action. Voting in elections is a conduit for expressing opinion about policies and acts of the government, and mass mobilization in support or opposition to particular institutions is largely absent. Moreover, a democratic polity provides enough checks and balances to keep all interest groups in the ambit of political structure, and economic decisions are therefore more consensual and less radical. This in turn gives flexibility to the system to manage political, economic and social tensions. In a word, in a highly heterogeneous society like India, the democratic process is very important for conflict resolution.

On the other hand, a one-party state such as China co-opts all interest groups within the party structure. Policies and programs once decided are implemented with collective zeal. This explains to a large extent how radical shifts in policy have taken place in China over the past 50 years, starting from the Great Leap Forward, to the Cultural Revolution, radical restructuring and reform from the late 70s, the reversal in the late-80s to the initiation of even more radical market orientation policies in the mid-90s (Bardhan, 2003).

The involvement of local leaders and common party cadres in initiating change in economic policy in China means that many of the reforms that occurred in the nonfarm sector in China were given an official stamp of approval long after they had been tested on the ground. In contrast, local governance in India was restricted to the state level until recently, and many policy decisions such as land reforms could not be completed in most parts of the country due to lack of political will.

When China started its major economic reform program in 1978, both land and human capital were much more evenly distributed than in India. Reforms provided rural people, in particular those in the coastal area, with an opportunity to develop the local nonfarm economy. Due to the attachment to their land, many people chose to work in the nonfarm sector locally so as to tend their land on a part-time basis. Moreover because the majority in the labor force was well educated, a large proportion of the population could share the fruits of economic reform by working in the nonfarm sector, especially in rural manufacturing. In contrast, due to the skewed land and human capital distribution in India, the less educated rural workforce seem to have lost out to the urban-based service industry that has benefited most from India's gradual liberalization from the early 1990s.

The initial endowment in the two countries, therefore, goes deeper than simplistic notions of democracy and state-control. Differences in the political, social and economic institutions have shaped policy toward the rural nonfarm sector to a considerable extent.

Ownership Structure: Private Initiative v/s Local Government Activism

The historical evolution of the Indian non-agricultural economy has seen a dualism between public ownership of heavy industry and infrastructure (roads, electricity, water supply, telecommunication, banks etc.) and private initiative in almost every other sector of the economy. There has never been any restriction to private enterprise and private property.

On the other hand, for nearly three decades after independence, China followed a policy of collectivization in agriculture and national ownership of heavy industries. Private property was illegal, and the State had the liberty to fix prices. As we have seen in the previous section, the 'price scissors' were used effectively against agriculture to transfer resources to the urban areas. Moreover, the *hukou*, or household registration system, was used to regulate labor movement between the towns and the countryside. Despite its tremendous distortions on the labor market, it has a positive side effect of promoting local industrialization. No such restriction has ever been imposed on labor migration in India.

This preamble is important for understanding the ownership structure of rural nonfarm enterprises in the two countries. As noted above, the nonfarm growth in India was an organic one, encompassing not only rural industry, but also service sectors such as trade, transport, community and social services (Table 1). There was no institutional barrier in setting up rural nonfarm enterprises by private individuals.

What the State did, however, was to regulate the *scale* of the enterprises, especially in manufacturing. The rural nonfarm enterprises were broadly classified into the *traditional* and *modern* sectors. The former were mainly home-spun cloth (Khadi) and handicrafts (pottery, basket-weaving etc.). The *modern* sector is divided into powerlooms which supply raw materials to the textile industry and all other types of manufactured goods and services that are present in the rural nonfarm sector. Over time, many manufacturing units have moved to the urban periphery, or have located themselves in rural towns to take advantage of market linkages and infrastructure, but are still classified as 'rural' enterprises. Both the traditional and the modern sector of rural enterprises fall under the umbrella of small-scale enterprises, encompassing those units below a threshold limit of capital investment, which is revised periodically.[5]

Therefore, the rural nonfarm enterprise sector in India is characterized by a clear ownership structure (private ownership of means of production), but not very clear

[5] The current investment ceiling is Rs.10 million (nearly $200,000), and Rs 50 million (nearly $1million) for technology-intensive industries.

demarcation vis-à-vis location of the enterprises. However, there is considerable government intervention in the form of investment ceilings, implicit subsidies in capital and marketing, and until recently, protection of small-scale industry through licensing and import barriers. In other words, the regulatory burdens have translated into high transaction costs of setting up and running a business despite clear property right arrangements.

China's rural nonfarm development, on the other hand, has largely been driven by the growth of the TVEs. Unlike India, it is the local, and not the central government, that took the lead in actively promoting the TVEs. Consequently, there is no evidence of any ceiling on capital investment limiting the scale of the enterprises, but considerable debate about the ownership and incentive structure of rural firms.

What is not in dispute is that the development of rural enterprises (REs) in China started from 1978 with the reform process. Most new entry firms were neither private nor state (i.e., national government) firms, but were owned and managed by the local governments (TVEs). In China, local governments played an active role in managing the agricultural collectives and the 'commune and brigade' under the old system. The management of local government bodies forms both the political and the administrative bureaucracy at the micro level.[6] Moreover, severe inter-jurisdictional competition forces local governments to create a business-friendly environment. This leads to a convergence in incentives for better performance in mobilizing resources for development. TVEs enjoyed a rather secure protection from the local government at the time when private property rights were not clearly defined on paper.

However, from the mid-1980s, there began a large and growing presence of private enterprises (PEs). It is in the analysis of the relative contribution of TVEs and PEs to growth of the rural nonfarm sector that the issue of ownership has assumed significance. One theory (Qian, 2003) is that local government ownership is a halfway house between national and private ownership of the means of production. In the absence

[6] This is different from India where the political and the administrative bureaucracies are completely different entities.

of the rule of law to protect private property rights until recently, this innovation in ownership structure is more secure than those of private enterprises due to the protection of community governments. From 1978 to 1993, the share of state-owned enterprises (owned by national or supra-local county governments) in total industrial output fell from 78 percent to 43 percent, while that of non-state firms increased from 22 to 57 percent. Disaggregating further, within the non-state firms, the share of firms collectively owned by townships and villages went up from 22 to 42 percent, and that of private firms was around 15 percent in 1993, up from being non-existent at the beginning of the reform period (Qian, 2003).

Because the rural nonfarm sector was not protected prior to the reform, China's rural enterprises have been able to capture the market niche left by state-owned enterprises and reap the benefits of scale. In contrast, there existed heavy regulations on both small-scale and large-scale industries in the private sector in India in the years prior to the start of economic reform. Therefore the private enterprises in China have more flexibility in terms of capital investment to adjust to increasing demand.

After liberalization, large-scale firms in India have reaped the benefits, while the village industry sector has suffered from low levels of labor productivity. The comparison shows that nominally defined secure property rights alone cannot guarantee the attraction of investment. Removing the distortions inherent in the economic system and introducing competition may have a more important role to play in the development of a vibrant rural nonfarm sector.

Provision of Local Public Goods

Differences in policy regarding ownership and promotion of the rural nonfarm sector are manifested in the provision of local public goods, especially infrastructure, in China and India. It is well recognized that the rural nonfarm sector needs supporting infrastructure, both physical and social, for sustained growth. In keeping with differences between the development paths followed by the rural nonfarm sector in China and India, there is a distinct difference between the way the provision of public goods has happened in the two countries.

It is now widely recognized in official and academic circles in India that availability of local public goods in the rural areas has become a major bottleneck in the last decade and a half (Planning Commission, 2001). As per the Industrial Policy Statement of 1977, industrial clusters were encouraged to take advantage of horizontal and vertical linkages. To promote rural small-scale industries, District Industrial Centers were formed, and entrepreneurs were encouraged to set up units with subsidized loans and reduced taxes. Nationalized banks had stipulated lending norms for loan disbursement in the 'priority sector'.

On the whole, central schemes and administrative guidelines to create an enabling environment for the rural nonfarm sector have not paid dividends. This is borne out by Table 2, where the share of the nonfarm sector in total NDP falls between 1980 and 2000. Although the share of registered rural manufacturing (essentially the modern small industrial sector) has increased, there has been a substantial decline in the share of unregistered manufacturing, which provides the bulk of employment in the rural areas.

In contrast, local public goods provision has been one of the critical inputs in the continuing growth of the rural nonfarm sector in China. Unlike India, rural community governments focus on providing local public goods – building roads, providing water and irrigation systems, maintaining law and order, etc. In this sense, the economic and social part of the administrative structure is more decentralized in China than in India.

In the context of the rural nonfarm development in China, provision of local public goods is the crucial link between economic and political objectives of promoting TVEs by local governments (Qian, 2003). Under the guidelines of the national government, nearly 59 percent of after-tax profits of TVEs were reinvested and the rest used for local public expenditure in 1992. This created positive linkages between performance of TVEs, with higher profits leading to greater ability to maintain and improve capital stock, and benefiting the local community in terms of infrastructure, which, in turn, encouraged diversification of the rural nonfarm sector.

Thus, decentralized provision of local public goods has been cited in the literature as one of the major factors sustaining the high growth of rural TVEs as well as PEs. The sharing of profit between the local and the national government creates a win-win situation, where higher reinvestment and better infrastructure leads to a cycle of growth in the nonfarm sector. However, questions have been raised recently about whether this creates path dependency in terms of the levels of development of the TVE sector between different regions of the country.

Financing the Nonfarm Sector: Institutional Lending v/s Non-conventional Finance

In the area of finance for the rural nonfarm sector, India and China have followed two very distinct paths.[7] The development of the rural sector in India, including both agriculture and industry, has been mirrored by government initiatives in the provision of organized credit from banks and other financial institutions. In 1973, when the Green Revolution was well under way in most parts of India, the government nationalized all domestic private banks, and brought them nominally under the control of the central bank. The demand for credit in the rural sector increased primarily due to the necessity of purchasing modern inputs such as fertilizer and machinery to augment agricultural production. Although lagging behind agriculture, the demand for credit from the rural nonfarm sector also went up in the late 1970s. If both sectors were to grow in a reasonably balanced way then clearly some specific government interventions were required.

In the literature on institutional factors underlying the growth of China's rural economy, the role of local governments and the incentive compatibility with regard to local government finances have received considerable attention. The government instituted a policy of 'directed credit' through the banking system in rural areas. Lending

[7] It should be aware that informal finance persists in both countries and plays an active role in the rural nonfarm sector (Tsai, 2004). Here due to page limits, we focus on the formal finance channels.

norms were instituted for the *priority sector*, which in the non-food component of the total bank lending included mainly small-scale industry. Location of such industry in semi-urban or rural areas was one factor that qualified them for priority sector credit. The ratio of priority sector lending in the nonfarm sector has been remarkably stable at around 36 percent over the last two decades. Moreover, the share of the small-scale sector in total gross nonfood credit has also not shown any fluctuation. This is in spite of the fact that between 1980 and 2000, there have been six changes of government, and economic reforms from 1991 onwards (Reserve Bank of India, Annual Reports, various years).

The stability of the priority sector lending indicates a general consensus in government towards the promotion of the nonfarm sector. This may be due to the fact that credit delivery has always been an instrument of patronage during elections, with declaration of loan-waivers and loan-holidays. There is a growing critique about the role of directed credit in the government policy from the efficiency angle, both in terms of targeting as well delivery mechanisms (Economic and Political Weekly, 2004). While a comprehensive review of government policy in this regard is outside the scope of the present study, a comparison can be drawn between the incentive compatibility of directed credit vis-à-vis decentralized system of financing that prevailed in China over the last two decades.

Unlike India, access to formal credit institutions for the rural nonfarm enterprises in China has been limited, at least in the initial phases. Institutional innovations have also been far more diverse (Tsai, 2004). In the absence of a formal banking system, private credit, rural credit cooperatives and local government support were the only means by which the TVEs could access capital. However, the cooperatives lend mostly to the State owned Enterprises (SOEs), leading to a transfer of rural household savings to the urban sector (Lin and Yao, 1999). Therefore, in explaining the productivity and efficiency of TVEs in rural China, the 'hard budget constraint' theory has received widespread attention (Bardhan, 2003).

Under the innovative ownership structure of the TVEs, local governments had complete control over their finances, which provided incentives for promotion of the sector. Higher profits meant higher revenues for investing in local public goods, which had both economic and political payoffs. Economically, regions with better infrastructure attracted more investment in the rural manufacturing sector, leading to higher employment and revenues.

The compatibility of economic and political incentives together with limited access to institutional lending translated into pressure on the management of TVEs to increase profitability. Higher revenues were divided between local public goods and reinvestment in plant and equipment. As noted above, by 1993, nearly 60 percent of TVE profits were being reinvested. The coastal areas of China emerged as the manufacturing powerhouse both in the domestic and in the export market. The benefits of organic linkages between local government initiative, local public goods and rural manufacturing have, however, been unevenly distributed across the country.

China's phenomenal nonfarm enterprise growth through unconventional financing pattern provides a stark contrast to that of the stability of directed credit policy in India. At first glance, the policy prescription for other countries may well be that decentralized finance works better for promoting rural nonfarm enterprises. Recent experience with rural co-operatives in the agro-processing and dairy sectors in India may also lead one to conclude that hard budget constraints and local initiatives work better in the rural nonfarm sector.

However, it must be kept in mind that China's local government structure is a product of its political system. The incentive compatibility, therefore, has a historical path dependency. In most developing countries, the lowest tier of government does not exist, or even if it does, it is not empowered as in China.

With the maturing of the market economy, China is also now setting up conventional institutions – an organized capital market and banking sector being two major institutional changes in that direction. With almost all the TVEs being privatized, credit constraints can force private enterprises to cut back on investment, leading to a slowing of rural nonfarm growth. The specter of a stagnant rural enterprise sector may lead China to follow India’s path of directed credit through commercial banks; early signs point in that direction (Lin and Yao, 1999, p.9).

IV. ASSESSING PERFORMANCE

The various policy initiatives and associated institutional arrangements that have been implemented in India and China in recent decades have influenced the performance of the rural nonfarm economy in a variety of ways. The resulting outcomes reflect comparative strengths and weaknesses of the sector in the two countries and will have a significant bearing on how the sector is able to respond to future challenges and opportunities. We discuss these issues below.

Strengths and Weaknesses of the Rural Nonfarm Sector in India

Performance

In India, the rural nonfarm sector existed in a primitive form at the time of independence in 1947. Over a hundred years of colonial rule had led to the systematic de-industrialization of key sectors of the economy, notably the handloom industry. In response, the Ghandian nationalist reaction included a strong populist call for promotion of village and khadi industries. This led to significant protection for specific labor-intensive village and khadi industries during the four decades following independence.

The initiation of economic reforms in the early 1990's, however, has effectively removed protection on these village and khadi industries. Less efficient than modern small industries (Chadha, 1993, 1996) and unable to compete on economic terms, many have closed down, leading to a halving of the rural income share earned in unregistered manufacturing establishments (Table 2). Over the same period, from 1980 to 2000, the share of registered manufacturing units has increased from 3% to 5% of rural income, helping to stabilize and even increase rural manufacturing employment slightly (Table 1). The rural manufacturing sector thus appears to be undergoing a process of re-adjustment where unviable units are being weeded out while others grow and maintain their competitiveness. With enabling policies along the lines of those adopted in China, rural manufactures can come out stronger in the process.

Rural services and commerce, however, have continued to grow rapidly. The green revolution period, beginning in the mid-1960s in India, saw a rapid increase in agricultural output and productivity. The nonfarm sector, especially rural services, grew to keep up with local demand. Though more spontaneous than planned, this growth in rural commerce and services accounted for over 90% of the rural nonfarm income and employment share gains over the past two decades (Tables 1 and 2). In general, India's growth story in the decade of the 1990s has been one of rapid expansion of the service sector, which now has the largest share in GDP. In some ways, India has bypassed the traditional progression from being an agricultural economy to an industrial one (Roach, 2004). With nearly 60 percent of the population still engaged in agriculture, there is an opportunity to redeploy labor to the rural service and commercial sector. One major strength of the Indian rural sector is the potential for structural transformation of the rural economy in the coming years, a process already achieved by China.

Table 5. Unemployment Rate in India – Rural and Urban (Current Daily Status Basis)

	Rural			Urban		
	Male	***Female***	***Total***	***Male***	***Female***	***Total***
1977-78	7.1	9.2	7.7	9.2	14.5	10.3
1983	7.5	9.0	7.9	9.4	11.0	9.5
1987-88	4.6	6.7	5.3	8.8	12.0	9.4
1993-94	5.6	5.6	5.6	6.7	10.5	7.4
1999-00	7.2	7.3	7.2	7.2	9.8	7.7

Source: *National Sample Survey*, various years

Recent trends in rural unemployment, however, raise challenges ahead. The lastest available figures show a sharp increase in rural unemployment, both for males and females, between 1994 and 2000 (Table 5). This is in contrast to the previous trend of decline in the rates of unemployment both in the rural and the urban sector between the late 70s and the early 90s. Given the context of extensive rural underemployment especially in agriculture, there is a danger that this open unemployment might lead to social tensions in the near future. To mitigate the crisis, successive governments have resorted to generation of wage employment through rural public works projects.

Although they were supposed to be temporary, political considerations have prevented them from being discontinued.

Strengths

(i) Institutional Basis for Rural Nonfarm Sector. In India, the institutions underlying the development of the rural nonfarm sector are very strong. These include secure property rights; a well-developed financial system with preferential access to credit for the sector; supporting institutions such as the Small Industries Development Bank of India (SIDBI), State industrial corporations; policies and programs promoting linkages with agriculture, especially agro-industries; domestic marketing channels for rural nonfarm production; as well as government support in export promotion. The institutional mechanisms for a rapid growth of the rural nonfarm sector are already in place.

(ii) Ongoing Decentralization Process. In a curious juxtaposition of political and economic considerations, over the last two decades the State governments in India have been able to exercise far more independence in decision-making than in the pre-1980 period. Regional parties are an integral part in coalition governments at the Center. In turn, they have negotiated economic autonomy in the formation of state specific policies for development. Moreover, with the opening up of the economy in 1991, foreign direct investment (FDI) has come to play an important role in the overall policy environment. State governments are in competition with one another to attract higher FDI levels both in manufacturing and infrastructure. In some ways, it mirrors the path followed by China, although the volume of FDI coming to India is less than 10 percent of that to China. On the positive side, however, this creates an opportunity for higher levels of investment in the future.

Weaknesses

(i) Infrastructure. The most significant bottleneck in generating higher levels of rural nonfarm activity in India is the quantity, quality and reliability of infrastructure. For

example, the recent World Bank Investment Climate Survey for India indicates that power outages were one of the most serious obstacles to the development of the nonfarm sector (Economist, 2005; World Bank, 2005). Although corrective steps are now being taken, increased infrastructure remains the most important priority for the future. To achieve a sustained growth rate of between 8 and 9 percent, the investment rate has to be stepped up from the current level of 24 percent to nearly 35 percent over the next decade, with investment directed at the rural sector (Planning Commission, 2000, p.57).

(ii) Regulatory Restrictions on Small-scale Sector. Regulation of the small-scale sector constitutes an important aspect of nonfarm development policy in India. In the initial stages, capital investment restrictions were imposed to protect the small-scale sector, especially in rural areas, from predation by large industry. Reservation of products for the sector was initiated to create a domestic market and quantitative restrictions imposed to protect them from competition from imports.

At the end of the 1990s, however, these very policies have become detrimental to the dynamism of the small-scale *sector*, especially in the rural areas. Capital investment limits have discouraged economies of scale, and concessions offered to small industry have created adverse incentives against re-investment. Several official reports have recommended a substantial increase in the capital investment limit (from the present level of around $200,000) to make better use of technology and improve productivity (Planning Commission, 2000). However, no such policy announcement has been made as yet.

Reservation of products for the small-scale sector has gradually reduced in significance, although this has created rents within the system.[8] The decision of the government to put all the reserved items in the open general license category from April 2005 would mean free import of such items at the prevailing tariff rate. With the latter slated to come down over time to around 20 percent as per the WTO norms, this will effectively signal the end of protection for the small-scale industry. Some sector

[8] There are instances of only one firm producing a reserved product (Bala Subhramanya, 2004).

examples, such as shoes and textiles, indicate that India's nonfarm sector can survive the competition both domestically and in the export market.

(iii) Quality of Manpower High levels of illiteracy in rural India have hampered the growth of the rural nonfarm sector. As is recognized today, education has both intrinsic and instrumental value (Sen, 1999). Apart from having a positive correlation with wages, a minimum basic standard of education is necessary to apply for credit, to be aware of one's rights and responsibilities and to deal with instances of corruption and malpractice. Often, a lack of education is intrinsic to poverty, which seems to have been the case in India until recently.

In the rural areas, lack of education leads to labor being stagnant in agriculture, or moving to casual work occupations in the nonfarm sector, and not to salaried employment with higher wages and benefits (Planning Commission, 2000). Together with lack of technical skills, there is little incentive for rural firms to invest in technology, leading to low levels of labor productivity in the rural manufacturing sector compared to urban manufacturing (Chadha, 2003). The same is true of the service sector as well, which has the potential for expansion given the already strong base in the urban economy. Higher investment to improve both the quality and the access to education – primary, secondary and above – needs to be a priority for policymakers.

Strengths and Weaknesses of the Rural Nonfarm in China

<u>Performance</u>

As the principal driver of China's economic expansion, the rural nonfarm sector is vibrant in many respects. While manufacturing continued to dominate rural nonfarm employment in China during the early reform years, evidence suggests that commercial and service activities have been growing more rapidly in recent years. Over the period from 1984 to 1997, employment gains in commercial and service TVEs increased by 45 million jobs, roughly double the 26 million jobs gained in manufacturing TVEs (Table 3).

This strong evidence of structural transformation is in large part due to the absorption of labor from agriculture into rural enterprises, as well as a high rate of technical change (Fan, Zhang and Robinson, 2003). This indicates that China's rural enterprise sector has broadened in scope and increased in scale, with positive effects on capital and labor productivity. Compared to India, China has been able to reap the benefits of scale economies, which has been noted even in official documents in India (Planning Commission, 2000). More ominously, signs of increasing regional inequality are emerging as well, driven by the very development of the rural nonfarm sector and public investments (Zhang and Fan, 2004). Moreover, financial sector rigidities may hinder the deployment of capital in the rural sector (Zhang and Tan, 2004).

Strengths

(i) FDI inflows and resulting technical change. Empirical analysis of China's economic transformation points to an important contribution of technical change. Fan, Zhang, and Robinson (2003) show for the economy as a whole, 42% of total GDP growth was from technical change, while in the rural nonfarm sector, the contribution was high at 53%. Foreign direct investment has accounted for part of these gains, bringing with it new technologies and ways of doing business. Scope still remains for increasing returns to capital by investing more in agriculture and rural industry. This offers the prospects for continuing productivity-enhanced expansion of the rural nonfarm sector (Fan, Zhang and Robinson, 2003).

The resulting productivity gains have benefited not only manufacturing but also service and commercial activity. China's 10-fold higher levels of FDI emerge significantly in the commercial sphere, where large regional and international retailers and supermarket chains have moved in large numbers (Reardon et al, 2003). In the year 2000 in food retailing, supermarkets held a 20% market share in China (nearly 50% in urban areas) compared to only 5% in India (Reardon et al., 2003). The introduction of modern supply chain logistics and just-in-time inventory management by large regional and international retailers has reduced marketing costs in China by as much as 40% (Reardon et al., 2003).

(ii) Private Property Rights. From the mid-1990s, the TVEs have been completely privatized through the creation of joint stock companies where the local governments are shareholders. This marks a significant step towards recognition of private property rights that have been accepted as reality by the political leadership. The change in ownership from local governments to private hands gives managers greater autonomy in running the firms, and can increase productivity and profit even further.

(iii) Strong Regional Competition. Regional policies in promoting rural nonfarm enterprises played an important role in the expansion of the sector. Different regions compete with each other in attracting investment and in opening up export markets. Regional competition in China created examples for catch-up within the country, leading to greater investment and output in the rural nonfarm sector.[9]

Weaknesses

(i) Domestic Financing of Rural Nonfarm Activity. China's formal lending institutions are still in the initial stages of maturity. The growth of TVEs and PEs until now has largely been through reinvestment of own resources. However, with increased competition, profit margins get smaller, and the quantum of investible resources consequently becomes less. In this context, a formal banking network with clearly defined lending policies is necessary for the rural enterprises to access capital, especially since formal financial markets (stock, bond, insurance etc.) are restricted. Sustained growth in the rural nonfarm sector therefore depends critically on devising transparent and targeted financial institutions such as those currently operating in India.

(ii) Protection of Workers' Welfare. In complete contrast to the rigidity of labor markets in India, the rural nonfarm labor force in China has few safeguards. Labor markets in rural China are demand driven, and managers of firms are under few

[9] A comparison can be drawn with the development of the software and computer services in India, where states are competing to attract high-tech companies.

restrictions to protect workers' welfare. While this arrangement can be beneficial for a massive absorption of labor from agriculture as happened in the decade of the 1980s, by the late 1990s labor market had become integrated in a very large measure. Although mobilization for labor rights is still rare in China, pressure of public opinion from export markets regarding the poor working conditions has already become an international issue. Moreover, a more balanced relationship between workers and capitalists will help reduce social unrest and ensure more sustainable future growth of the nonfarm sector in China.

(iii) Regional Inequality. Although increasing regional inequality is a matter of concern for both China and India, the problem is more acute in China. Before economic reforms were initiated in the late 1970s, the emphasis had been on eliminating differences between regions through investment in social and physical capital. From the early 1980s, different regions started *growing* at different rates (Kanbur and Zhang, 2005). Nonfarm sector growth has been one of the main contributors to this divergence in regional development trajectory.

From the emerging intra-regional inequality studies, the limits to privatization are becoming evident as well. One factor is the withdrawal of the government from education and health spending. Indicators of health and education in poorer regions of the country are actually showing signs of retrogression (Zhang and Kanbur, 2005). This has long-term implications for the quality of the labor force in the rural areas, as we have seen in the case of India. The warning signs for China should be India's neglect of social capital investments over the last five decades.

V. CONCLUSIONS: TOWARDS GREATER NONFARM POLICY CONVERGENCE

In spite of diametrically opposite political philosophies in post World War II China and India, many of their policies governing rural nonfarm activity proved remarkably similar. After an early period of neglect, agricultural productivity growth became the cornerstone of rural development strategies in both countries, leading to a generally prosperous farm sector. This formed the base of the demand for nonfarm goods and services in the rural areas, though more in the case of India than China.

In India, the policy of protection and promotion of the nonfarm sector in the eighties was followed by the sudden opening-up of the sector to competition in the early 1990s. Under the new competitive environment, most small firms, especially those run by households with primitive technology, lost out badly in the period of competition and market integration that followed. The shakeout in the rural nonfarm sector is continuing even now.

Because of fewer price and quota protections on the rural nonfarm sector, China's TVEs became internationally competitive more quickly than India's rural nonfarm manufacturing enterprises when its economy was liberalized. In China, in the planned era, protection was mainly on the state owned enterprises. With the success of rural and agricultural reform in the early 1980s, agricultural productivity increased dramatically, channeling surplus to the development of local rural enterprises. Since the 1980s, China has adopted a fiscal decentralization policy, providing a strong incentive for local governments to develop the TVE sector because they can keep most revenues from TVEs. Facing hard budget and inter-jurisdictional competition, TVEs must be productive to survive in the marketplace. As a result, the viable TVE sector gradually takes the share of relatively inefficient state-owned enterprises. Coupled with open-door policy and export promotion, TVEs reaped the benefit of both internal and external market linkages. Except during a short time period between 1989-1991, there has been comparatively greater policy consistency vis-à-vis the rural nonfarm sector in China than in India.

However, the issue of credit and finance to the rural nonfarm sector concerns policymakers in both countries. Although India has a more well-established network of rural credit, it suffers from inadequate delivery systems, which lead to bottlenecks in technological upgrading and output expansion. China on the other hand is in the process of setting up systems of credit delivery through normal banking channels, and setting up institutions to monitor the same.

Until now, China's high rates of FDI inflow have contrasted with the low levels for India as a reflection of the future potential of the two countries. This has been challenged recently, and the focus has shifted more towards the underlying institutional differences. It has been argued that the opening-up process is more stable in the case of India, where there is already a strong domestic manufacturing base, along with the support of a well-developed financial system and corporate governance (Huang and Khanna, 2003). Given more flexible labor-market policies and a lifting of restriction on the scale of enterprises, India is poised to attract significantly higher levels of FDI in the manufacturing sector in the coming years. Judging by China's experience, the rural nonfarm economy holds the potential for contributing to future economic growth in India.

Pessimism about China stems largely from the slow pace of creating transparent capital markets and judicial system, leading to rent seeking and corruption (Tseng and Zebregs, 2002; Zhang and Tan, 2004). Moreover, with nearly 90 percent of FDI going to coastal provinces in the south and east, regional inequality is growing much more rapidly than in India. The major challenge facing China in the coming years is to realign policies for a more equitable growth, both within and between regions.

A review of the strengths and weaknesses of the rural nonfarm economy in China and India reveal interesting points of contrast. Financial institutions catering to rural industries are one of India's strengths, but are in the process of development in China. Physical and social infrastructure is a bottleneck for India but is one of the factors driving rural nonfarm growth in China. Decentralization and inter-regional competition has so far worked well in China, whereas centralized decision-making and redistributive allocations have stymied competition in India. However, as China's recent experience shows, there needs to be a balance between decentralization and withdrawal of government's role especially in the social sectors. There are lessons to be learnt from both countries in this regard.

India can learn from China on how to create a business-friendly investment environment by continuing to remove the regulatory burdens on small rural nonfarm enterprises and their transaction cost. For China, it is time to learn from India to better protect the rights of both investors and workers as conflicts increase along with the scale of the rural nonfarm sector.

Worsening inter- and intra-regional inequality in nonfarm development is probably the most pressing issue facing policymakers in both countries. Both countries face migration from regions of low rural nonfarm development to regions of high growth. As China and India face similar challenges in the future, we anticipate greater convergence in their rural nonfarm policy directions.

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