Soft vis-à-vis Hard Infrastructures for Economic Growth:

Can China Learn From India?

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There is now mounting evidence that India enjoys some substantial advantages—in the areas of property rights security and financial system—over China and these advantages are sources of some very remarkable progress the country has made both microeconomically and macroeconomically. It has created some world-class private sector firms, not just in computer software but in pharmaceutical sector and auto components. My prediction is that after the textile quotas are removed in 2005, India will become very competitive in garment and textile industries as well. At a more macro level, India’s economic growth has been quite admirable. It is lower than the Chinese growth rate for sure but it is able to achieve a respectable growth rate on a sustained basis without major fluctuations of growth rates and with a fraction of investment resources that China uses to drive its growth.¹

Whether India is able to overtake China or not is far less important than the fact that its growth model offers some valuable lessons for China. The right way to compare the two countries is not to mechanically compare the size of the economy and the production capacity but to look at the ability of one country to use its resources effectively and efficiently to create value. From the latter perspective, India has done remarkably well and China’s performance is less impressive. To understand why India’s growth rate—averaging around 6 percent since the early 1990s—is a stunning success, we have to appreciate that the odds are enormously against achieving fast economic growth in India. First, let’s start with its location. A substantial part of India is located in a tropical region of the world and this simple fact constitutes a huge disadvantage. Today almost all the rich countries are located in the temperate zone of the world and this is no coincidence. Economic research shows that tropical environment is hostile to economic growth. Contagious diseases are rampant; it is difficult to develop agriculture, whose surplus has traditionally financed industrialization, and productivity of workforce is lower. The only tropical country that has succeeded in industrialization is Singapore.

The second huge disadvantage of India is its ethnic diversity. Despite the common perception that India enjoys an English advantage over China, in fact only 30% of its population understands English. This is a country without a national language and it is a country that has a

¹ Some of the data used here are new but the argument is based on my previous research projects. Please see (Huang 2003) and (Huang and Khanna 2003).
history of ethnic and sectarian violence. Again, economic research shows that ethnic diversity hinders economic growth. Much of the blame for “African tragedy”—that its economic growth has either been stagnant or negative since the 1960s—goes to its multi-ethnic character of the continent. Every single economy that has caught up with the West since the WWII—defined as obtaining a per capita income around 15,000 dollars—has been a country or region with a single dominant ethnic group—Japan, South Korea, and Taiwan. Singapore, the most ethnically diversified country in East Asia, also has a dominant culture centered around Confucianism.

There are other disadvantages, including a low level of education.

In this article, what I am going to do is to present some quantitative evidence that India enjoys some substantial advantages in soft infrastructure.

**Hard and soft infrastructures for economic growth**

Economic growth depends on the quantity and quality of both hard infrastructures and soft infrastructures. By hard infrastructure, we mean roads, airports, ports, etc. By soft infrastructure, we mean a country’s legal, regulatory and financial systems. Both hard and soft infrastructures contribute to economic growth but they do so very differently. Building up and investing in a country’s hard infrastructures has an immediate effect on growth. Because investment is a component of GDP, increasing investment will increase growth. The economic payoffs from building up soft infrastructures are not immediate but only show up in the long run. The payoffs do not necessarily get reflected in the rate of the growth but in the quality of growth.

The other difference is that it is easier to see the results of building up hard infrastructures than it is to see the results of building up soft infrastructures. An airport, once built, is visible to all but it is much harder to tell whether or not a country’s financial system has improved. Soft infrastructures are harder to measure and their main effect is to improve investment and work incentives of individuals rather than to create physical and tangible projects. Even a casual observer can tell the difference in the physical landscape of Beijing between 1994 and 2004 but without due diligence and some expertise it is difficult for one to tell the difference in Beijing’s financial system between 1994 and 2004. Similarly, it is easy to under-appreciate some of the strengths of India because the country has been able to make substantial progress in its soft infrastructures without much change in its hard infrastructures. For China, it is the other way around.

By the measure of hard infrastructures, China is clearly ahead. According to estimates by Morgan Stanley, China’s highway network is about seven times that of India. In 2002, China invested about 260 billion dollars in electricity, transportation, communication and real estate sectors compared with India’s 31 billion dollars. India has a huge electricity shortage. Many of its firms
operate their own generators, which vastly increases the unit costs of electricity. According to the same Morgan Stanley study, India’s electricity costs in manufacturing are double of those in China and India’s railway transportation costs are three times as much as China.

By the measure of soft infrastructures, India is clearly ahead of China in certain critical dimensions such as property rights security, availability of financing to private firms and corporate governance. It should be emphasized that India’s advantages in soft infrastructures are not across-the-board. In the areas of tax and labor regulations, China is in fact ahead of India. What this exercise shows is that India and China are strong in different areas, not that one dominates the other country in all areas. But it should be noted that those areas in which India is strong, such as property rights security and financing availability, are the most critical factors for economic growth. India’s regulations are more complicated and bureaucratic than Chinese regulations but most market economies have complicated regulations. India’s case stands out not because it has complicated regulations but because it has such complicated regulations at a very low per capita income.

Financial markets

As a first cut, I rely on the World Business Environment Survey (WBES) designed by the World Bank. The survey was designed to capture firms’ views on many aspects of a business environment pertaining to their operations. An important feature of WBES is its emphasis on entrepreneurial firms. Vast majority of the firms are owned privately. Only 12 percent of the firms reported having some government ownership. Thus this survey can be read as reflecting not the business environment for all the firms but for privately-owned firms specifically. This is an important feature for our analysis because so much of argument rests on the differential treatments of domestic privately-owned and entrepreneurial firms between China and India. The survey was implemented in 1999-2000 period and it covered 81 countries and some 10,000 firms. A huge advantage of this survey is that for the first time both China and India are included in a single survey. This enables us to compare the two countries directly.

WBES is useful to illustrate some of the substantial differences in the state of financial markets in these two countries. WBES contains several questions about financing and credit availability to firms. One original survey question is: “Please judge on a four-point scale how problematic are the following factors for the operation and growth of your business.” To this question, 80.2 percent of Chinese firms ranked financing as a major constraint on their business but only 52.1 percent of Indian firms were substantially constrained by financing. The greater financing constraints faced by the Chinese firms are shocking in light of two facts. One is that China is not just ranked below India; in fact in WBES China is ranked at 78th out of 81 countries. The three countries that received a poorer ranking on financing constraint than China are Ukraine, Moldova, and Russia.
The second fact is that China has a far bigger banking sector. In 2001 for example, domestic credit provided by banking sector as a percentage share of GDP was 132.7 percent in China but only 53.8 percent for India. Thus Chinese banks lend more than twice as much as Indian banks but Chinese private firms are more financially constrained. Other parts of the WBES corroborate this conclusion. For example, retained earnings accounted for 56 percent of the sources of fixed asset investment financing among the sampled Chinese firms in WBES, compared with 27 percent among the sampled Indian firms. An amazing statistic is that local commercial banks only accounted for 9 percent of fixed asset financing among the sampled Chinese firms, compared with 22 percent for Indian firms in the WBES. The reason why this is amazing is that China has a far bigger banking sector than India does.

An equally interesting finding is that while both Indian and Chinese firms face financing constraints, albeit to a different degree, the reasons for these constraints differ dramatically. WBES asks firms to identify reasons why their financing constraints arise in the first place. Five sources of financing difficulties are given in the WBES: 1) collateral requirements, 2) bank paperwork, 3) high interest rates, 4) special connections, and 5) banks lack money to lend. On four of these measures, Chinese firms in fact provide better ratings than Indian firms. For example, 50.5 percent of Indian firms view collateral requirements as a “major” or “moderate” obstacle toward obtaining finance, compared with only 20.2 percent of the Chinese firms with this view. Indian firms complain viscerally about bank paperwork (50.5 percent), high interest rates (81.2 percent), and needing special connections (35 percent). In contrast, the Chinese scores for these three categories are 29 percent, 35.4 percent, and 25.3 percent.

The Indian complaints are typical of a backward banking system one often finds in a developing country. The banks possess poor risk-assessment capabilities and lack information about their potential customers. To play safe, they often require a lot of collaterals, impose onerous bureaucratic requirements, and resort to exorbitant interest rates in order to price out the risks. A sophisticated banking system obviates these blunt instruments; for example, in the WBES, the scores for American firms on these dimensions of financing constraints are considerably lower than the Indian scores.

Indian firms, thus, are credit-constrained for technical reasons. Their list of complaints will ring a bell with many entrepreneurs located in a developing country endowed with an under-developed banking sector. This is a development story par excellence.

Although many do not bother to do so, it is analytically useful to make a distinction between an under-developed banking sector and a biased banking sector. Recall the finding that Chinese firms complained far less about collateral requirements, paperwork, high interest rates, and special connections than Indian firms. In fact, the Chinese scores in these four categories are better than
American scores. Does this suggest that China has better banks than the United States or India? Hardly. A far more plausible explanation is that these banking practices matter little to a firm if that firm never gets a loan. Until 1999, the four biggest state-owned banks, which account for vast majority of banking assets in 2004, were categorically banned from lending to the private sector. Thus the most critical difference between India and China is that India has an under-developed banking sector but China has a biased—and under-developed—banking sector.

Is there any evidence in WBES that supports this claim? Yes, indeed. On the question—whether banks lack money to lend, 37 percent of the Chinese firms answered yes but only 18.5 percent of the Indian firms did so. But we know that Chinese banks are flooded with deposit capital and that Chinese banks lend generously. So what is going on? Recall that the main emphasis of the WBES is to poll the opinions of private firms and here is the answer: The entire Chinese banking system is oriented to serve SOEs, not private firms. Thus private firms sampled by the WBES—many of them are probably the best and largest in the country—are completely side-stepped by China’s enormous banking system. The financial bias against private firms extends well beyond the banking sector and characterizes China’s entire financial market. In the WBES, equity financing accounted for 2.6 percent of the fixed-asset investments for our Chinese firms; for Indian firms, it is 5.2 percent.

One of the huge soft infrastructure advantage on the part of India is that it has a more efficient financial market. This advantage is often under-appreciated on the one hand or flatly misunderstood on the other. Indian banks have a lower NPL ratio and the banking sector is far more open to FDI than the Chinese banking sector.

There are two main reasons why India has a better banking sector. First, it is less burdened with the kind of ideological bias as the Chinese banks. Second, India began banking reforms far ahead of China, not as a proactive government policy but because it was pressured to do so. Here is a very interesting illustration of differences between the two countries. The banking reforms apparently were pushed by a depositor lawsuit filed in the early 1990s against a state-owned bank, arguing that the bank should publicize its lending criteria. The argument is that the bank has accumulated all sorts of NPLs and was endangering his rights as a depositor. Due to this lawsuit, the bank and the state-owned banking industry as a whole began to explicitly publicize their lending norms and thus increased transparency. This is unheard of in China.

**Property rights security**

Property rights security is a substantial soft infrastructure advantage in favor of India. Can we demonstrate this point apart from the anecdotal accounts? WBES reports that tax compliance is much worse in China than in India. In fact, the data presented in this table understate how bad tax
compliance in China is and let us provide a few more details to amplify this point. In the WBES, only 11.9 percent of Chinese firms believe that a typical firm in their industries report 100 percent of their income for tax purposes. For India, this ratio is 41 percent. The Chinese score on this question is one of the lowest among the WBES countries. At 11.9 percent, China is in striking range with such countries as Haiti (11.7 percent), Malaysia (13 percent), Bangladesh (12 percent), and Kyrgyzstan Republic (16 percent), none of which, except for Malaysia, can be considered as an economic model to be emulated. India, at 41 percent, is in a more respectable company—United States (45 percent), Portugal (42 percent), Spain (49 percent), and Sweden (46.1 percent).

Let’s speculate about why an entrepreneur is motivated to hide taxes from the reach of the state. First, we should stipulate that an entrepreneur is normally motivated to operate above ground rather than under the ground. It is easier to grow the business that is legitimate and contracts with customers, suppliers or creditors are only enforceable if these contracts were entered into over the table. Thus to the extent we do observe underground economy there must be policy and institutional distortions at work. This is a standard framework in the economic analysis of informal economy and we use it here to account for the differences between China and India.

There are two plausible scenarios. In one, an entrepreneur is slapped with exorbitant taxes on his income, which reduces his returns on investments of his efforts, money and time. One of the most effective ways to evade taxes is to operate underground. Many countries, including Italy and Russia, have long been afflicted with this problem. The other scenario is that our entrepreneur lacks property rights security. He may fear that the state will appropriate both the post-tax returns from investments of capital, efforts and time and the accumulated assets. This fear will reduce his motivation to report taxable income faithfully. The reason is very simple: Taxable income is a way to reveal to the authorities that you have a lot of wealth and is a sure way to invite predatory attentions.

Property rights insecurity, arguably, constitutes a stronger incentive to go underground than a high tax regime because the state can predate on both the flows—income—as well as wealth, such as assets, of an exposed entrepreneur. Indeed, in a cross-country analysis, a number of economists found that lack of property rights security explains much of the variance in the informal economy across xx countries. Tax rates explain only a small portion of the phenomenon.

There are a number of indications that high taxes and poor tax regulations drive Indians to cheat on their taxes and that property rights considerations motivate the Chinese to do the same and to do it on a larger scale. It turns out that Chinese firms in the WBES complain far less about taxes and regulations than do their Indian counterparts. On taxes and regulations as a major obstacle to their business, 28.7 percent of Chinese firms in WBES answered in the affirmative but 39.2 percent of the Indian firms did. The WBES questions specifically designed to probe into tax issues elicited exactly the same responses. On questions whether high taxes and tax administration constitute major
obstacles to their businesses, 50 and 30 percent of Chinese firms answered yes respectively but 67.9 and 41.2 percent of Indian firms did.

The higher incidence of fraudulent income reporting in China as compared with that for India is not matched by the patterns of data on tax burdens and thus the default explanation—property rights insecurity—is more applicable here. One relatively direct piece of evidence has to do with the quality of the court system. We typically turn to the legal system to resolve business or title disputes and we do so only when there is confidence that the court system is neutral and fair. In India, the court system, however inefficient or even corrupt on its own accord, is at least independent from the executive branch of the government. In China, the Party controls the entire court system and there is no meaningful separation between the executive branch of the government and the court system.

WBES provides some limited data that the Chinese court system lacks fairness and honesty as compared with the Indian court system. WBES contains the following question, “In resolving business disputes, do you believe your country’s court system to be 1) fair, 2) honest, 3) quick, 4) affordable, 5) consistent, and 6) enforceable?” Percentage of Chinese firms who chose “seldom” or “never” for the “fair” category is 34.4 percent, compared with 21.4 percent for the Indian firms. 44 percent of the Chinese firms believed that their court system is seldom or never honest, as compared with 30.3 percent of Indian firms with the same opinion. Overall, Chinese firms had a higher opinion of their judiciary than Indian firms. The reason is that the Chinese court system scored better than the Indian court system on the quickness (58.2 percent of the Chinese firms who chose “seldom” or “never” in their answers vis-à-vis 89.1 percent of the Indian firms), affordability (34.1 percent vis-à-vis 63.5 percent), consistency (38.6 percent vis-à-vis 42.9 percent), and enforceability (34.5 percent vis-à-vis 44.8 percent). Thus a Chinese entrepreneur can expect a more accessible, efficient court that renders judgments that can be enforced. But just do not expect those judgments to be correct.

**Corporate governance**

In this section, we take up an area of soft infrastructure not covered by the WBES—corporate governance. There is little distinction between good management and good corporate governance, which encompasses the fair treatment of minority shareholders and other stakeholders, as well as management and financial discipline. Higher quality of corporate governance is a reliable reflection of quality of management.

India knew corporate governance before it knew Enron. On corporate governance dimension, China is not even close to what India has achieved. Direct comparisons between the two countries in corporate governance performance have been rare. The one fairly systematic study that
went beyond numerical rankings is the CLSA Report on “Corporate Governance in Emerging Markets” published in April 2001.² We summarize some of the key findings below.

Brokerage and investment banking firm CLSA Emerging Markets uses seven key criteria to constitute the concept of good corporate governance, and developed a questionnaire covering 57 CG issues for its analysts to use to evaluate key companies in multiple emerging markets. The seven key criteria are:

1) management discipline
2) transparency
3) independence
4) accountability
5) responsibility
6) fairness, and
7) social responsibility

On CLSA’s weighted scoring scale of 1-10, India scored an overall 5.4 for corporate governance, while China was considerably further down the list of countries surveyed, at 3.4. In terms of cross-country ranking, India was ranked sixth in the study; China, 19th. Two factoids are worth mentioning here. First, India’s performance is good relative to China but it is not superb. In the same study, by comparison, Singapore scored 7.4, Hong Kong, 6.8, and Taiwan, 5.3). Second, the fact that Taiwan scored so much higher than China underscores the point that corporate governance should not be thought of as an English institution. It is not due to a linguistic or cultural bias that China is ranked so low as compared with India.

The CLSA report assigned higher scores to India than its overall score in particular areas of corporate governance. India did much better than China in corporate governance rules and regulation, as well as enforcement of such regulations and “institutional mechanisms and corporate governance culture.” (p. 37) The report lauds the effort of certain Indian companies to set their corporate governance standards beyond mandatory requirements. (as we will see later in this book, Infosys has been a pioneer in this area.)

In January 2000, the Securities and Exchange Board of India (SEBI) adopted the Mangalam committee recommendations, which included: 1) corporate boards to include no less than 50% non-executive directors, 2) a board committee chaired by a non-executive director that listed companies must set up to address shareholder and investor complaints, 3) annual reports to include a separate section on corporate governance and contain a detailed compliance report.

² See (Gill 2001).
It is telling that many of the Indian companies rated poorly by the CLSA report are government-owned firms and this provides a clue as to why corporate governance performance in China has been poor. Inadequate regulatory environment—many sensible corporate governance practices could be legally required but currently are not. The CLSA report identifies the following problematic areas in China’s corporate governance. First, the state remained the majority shareholder, thus enabling the political agenda to take precedence. Second, very few Chinese firms issued public statements or annual reports discussing corporate governance issues. There did not appear to be a sense of urgency and purpose about instituting good corporate governance among Chinese companies. Third, the Chinese companies did not have proper incentive schemes for its management. Fourth, investor relations remained weak. Fifth, board members and company chairmen were not sufficiently independent from management and they played a more executive rather than supervisory role. Most top managers in state owned companies were political appointments, whereas the founders of most private companies usually held the chairmanship and dominated the company. Most boards were too big and too unwieldy in any case.

China’s two stock exchanges—in Shanghai and in Shenzhen—have been heavily crowded with government-controlled firms. Among these firms, non-executive board membership is scant and the operations of the firms are either tightly controlled by the insider management or by the government. According to a detailed study of over 600 firms on the Shanghai Stock Exchange (SHSE) and the Shenzhen Stock Exchange (SZSE) in 1995, the three main groups of shareholders, the state, legal persons, and individual shareholders, each controlled about 30 percent of outstanding shares. This three-way equity split has been preserved to this day. Under the current securities regulations, the state and legal person shares are not tradeable. As long as the state and legal person shareholders together exercise controlling and non-alienable equity interests, the two stock exchanges cannot function as “markets for corporate control.” And the government will retain undisputed control rights.

A 1997 World Bank report provided some interesting details about how this state-centered shareholding structure would hamper corporate governance. The board membership of the listed companies is not proportional to the ownership. Although individual shareholding constituted 30 percent of outstanding shares, according to (Xu and Wang 1997), on average individual shareholders only occupied less than 0.3 percent of the seats on the boards of 154 companies, while the state was over-represented. On average, the state retained 50 percent of the seats even though its equity shares amounted to 30 percent. There are no proxy voting procedures, which puts individual shareholders in a disadvantageous position vis-à-vis institutional investors such as government agencies. This usurpation of rightful shareholder power is a reflection of the reluctance to relinquish control on the one hand and of a failure to adhere to even rudimentary corporate governance norms and rules.
Is there a way to quantify the effect of the differences in corporate governance on the stock markets in the two countries? Three US economists, Randall Morck, Bernard Yeung and Wayne Yu, wrote a famous paper showing that in countries that have poor corporate governance, poor information disclosures and poor minority investor protection stock prices of listed companies on the stock exchanges tend to move together rather than individually. They developed a statistical measure of this phenomenon and on that measure China has a score of 0.80, meaning that 80 percent of stock prices tend to move together, and India has a score of 0.695. By contrast, the best stock market in the world has relatively low values. US has a score of 0.579. (Morck, Yeung and Yu 2000)

**Regulations**

One major soft infrastructural advantage China has is in the area of regulations. Chinese regulations, for example those over taxation and labor hiring and firing, are far less complicated and cumbersome than Indian regulations. Any entrepreneur who has operated a business in India knows how difficult it is to deal with India’s myriad labor laws. In a recent issue of the Global Competitiveness Report, India is ranked 73rd out of 75 countries included in the study in terms of labor flexibility. China, by contrast, is ranked 23rd. In the WBES survey quoted earlier, only 16 percent of Chinese firms view labor regulation as a major obstacle on their businesses but in India the ratio reaches 63.7 percent.

WBES survey also found India’s tax and regulations more cumbersome than their Chinese counterparts. Apart from labor regulations, WBES contains seven questions specifically assessing the tax and regulatory environment. These seven questions cover: 1) business registration, 2) customs, 3) foreign currency, 4) environmental, 5) fire, 6) high taxes and 7) tax administration. While Indian and Chinese firms faced similar levels of obstacles in the area of business registration (27.7 percent of Chinese firms view business registration as a major obstacle, compared with 26.2 percent of Indian firms), on each of the other dimensions, Indian firms fared worse as compared with the Chinese firms. On tax administration, 41 percent of Indian firms view it as a major obstacle, compared with 30 percent in China. High taxes were a major problem for 50 percent of Chinese firms but 67.9 percent for Indian firms. 30 percent of the Chinese firms viewed tax administration as a major obstacle; 41.2 percent of Indian firms did. 19.8 percent and 14.4 percent of Chinese firms viewed environmental and fire regulations as a major obstacle; 40.6 and 20 percent of Indian firms did so. The evidence that Indian firms have to struggle with more onerous and cumbersome regulations than Chinese firms is overwhelming.

It is important to understand precisely the effect of complicated and cumbersome regulations on economic activities. Inefficient regulations deter economic activities across the board
but usually there is still room for efficient and entrepreneurial firms to grow even under a complicated regulatory regime. As long as entrepreneurs have property rights security and financing, they can overcome the adverse effects of poor and inefficient regulations and they can still grow and expand. Inefficient regulations can make an entire economic sector small but they do not necessarily reduce the scale and scope of individual firms.

The best example here is the comparison of textile/garment industry between India and China. What is interesting here is that although the size of garment/textile industry is much bigger in China than in India, the individual Indian firms are actually quite competitive and they occupy in higher value niche than Chinese firms.

At a comparable labor cost and other economic fundamentals, India is only exporting a fraction of what China exports. India is now exporting about 15 billion dollars in garment and textile products compared with China's 80 billion dollars. As in many other product segments, India is hard pressed to compete with China on scale. But again India may have an underappreciated advantage at a microeconomic level. The unit value of its garment exports is actually quite high. (Ghemawat and Patibandla 1999) estimated that in the mid-1990s the average unit value of Indian garment exports was around 5 dollars. To the authors, this was evidence that Indian garments were priced at the bottom of the product categories. Data for more recent years indicate that the unit value of Indian exports has declined. India's export of readymade garments, to restricted countries, during January-July 2002 amounted to 714.5 million pieces which are valued at $2,497.7 million. This works out about 3.5 dollars per piece.

Low as they are, these average unit values are in fact higher than what the Chinese garment exports were able to command. In 1999, China exported 9.1 billion pieces of garments to the tune of 24.4 billion dollars. This works out about 2.67 dollars a piece. In 2001, the average unit value declined to 2.3 dollars and in 2004 it was 2.19 dollars. By at least one measure, the firm-level productivity performance is not substantially different between China and India. The measure here is the dispersion of value added per worker given by the ratio of the value added of firms in the top 25 percent to the value added of firms in the bottom 25 percent. The data on which this measure is based is for 1999. Surprisingly, China and India are very close by this measure. In garments, the ratio for India is around 5.7; for China, it is 5.6. In electronics, China in fact does worse than India.

**Conclusion**

India and China have embraced two very different growth models. Each model has its own advantages and drawbacks but there is increasing evidence that the Indian model—by emphasizing soft infrastructures—has the potentials of delivering long-run economic payoffs. This is not an
argument that investing in hard infrastructures is not necessary; it is necessary but China will soon run up to the limits of massive investments if it does not improve its soft infrastructures. For more than ten years, India has drawn lessons from China—by trying to increase its investment rate and to open to FDI. Is it time now for China to take some valuable lessons from India about its strengths in soft infrastructures? I believe it is.
Bibliography


