Lecture Text
Professor Tarun Khanna
Billions of Entrepreneurs: The Yin and Yang of China and India*

(*edited for clarity*)

Introduction

So the one thing that I want to communicate is that personally I'm often asked, will China stay ahead of India? Will India overtake China? Whatever. You know, at some level, point number one is both societies are on the move for the first time in a long time, and that is nice because it alleviates poverty and does good things for good people. So that is nice.

The second thing is that I think the systems are not rankable because they have different pluses and minuses. And it's very hard to step back and say, "This is unambiguously better than the others." They have different pros and cons. And as businesspeople in the world, I think what I would like us to understand is just what those pros and cons are at a simplified, abstract level. So that's what I would like to communicate.

This paper was handed out to you. It's titled "Can India Overtake China?" That was the editor's choice as opposed to ours. We intended the paper to say that there are real differences. But I guess that wasn't sexy enough for the editor. My colleague Huang Yasheng, who is a native Chinese, who was at HBS at the time and is now at MIT, and I were heavily criticized across the world for publishing this article and heavily praised. And there is a story in there that I'll tell you also, if it becomes germane.

We were criticized because people thought it was preposterous in 2003 to say that anything good could happen in India. And the point that we were just making was, look at the aggregate indicators of microefficiency. And we said, "If you look at any of these indicators, you'll see that the Indian system on a per-unit basis is far more efficient." And so, ultimately the macro figures have to catch up with that underlying aggregate microefficiency. That was really the point that we were making.

And so you shouldn't write that off in favor of a state-led model of much rapid growth but higher degrees of inefficiency. And that was the point. It was criticized in the two years since. I think what we have said is now becoming a little bit more accepted wisdom, at least the point that there are different pros and cons.

Policy Choices

Let me explain this diagram. On the left, *G* stands for government, *D* stands for domestic private sector, *F* stands for foreign private sector. And on the left, what it says is that the China story, to caricature, is really a story of government getting into bed with foreign enterprise. In other words, if you are a state-owned enterprise in China, you are OK in the sense that, the privatization notwithstanding, you still are treated well. Your property rights are respected, etc. It's a simplification but I'll stick with it for a bit.

And if you are a foreign investor, you are welcome. The foreign direct investment, initially from the overseas Chinese communities, but increasingly from all over, has been very welcome. And many of you have probably invested in China. And the Chinese are just absolutely spectacular at

* Lecture based on *Billions of Entrepreneurs: How China and India Are Reshaping Their Future and Yours,* by Tarun Khana, Harvard Business School Press, February 2008.

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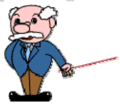

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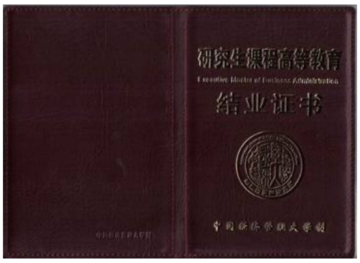

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making you feel at home, including making people from India feel very much at home in investments in China. And I think that is something India has to learn from China in a big way.

On the other hand, if you are a domestic entrepreneur—and there is no shortage of domestic entrepreneurs in China. There is a lot of hustle on the street. Anybody who walks around will see that the intent is as strong if not stronger than anywhere else in the world that I've been. But the system is not set up to support domestic entrepreneurs, indigenous entrepreneurs.

So I want to be very careful about the words that I'm using, all right? The private sector encompasses both *D* and *F*. So you can't summarize this by saying that it is pro-private sector or anti-private sector. It is pro-foreign private sector. It is anti-indigenous private sector. Why is that is a whole separate issue. Is this a political conspiracy story about the party being suspicious of entrenched interests outside of the party? Or is it just a story of crowding out, where the dominant state-owned enterprise system makes it very, very hard for local people to get capital?

And you can find somebody who will support every version of conspiracy story out there. And I don't really have a point of view on that. There's a descriptive matter. As a private entrepreneur, you can only go so far before you either decide that you want to stay at that point or you get into bed with some aspect of the state and move forward.

That, by and large, the problem here is that—and it's OK for the country not to have a domestic financial market to a first approximation, because much of the economic activity is happening here. And these guys are using foreign capital markets. These are the Hewlett-Packards, and the IBMs, and whatever else—pick your company—who are building big facilities in China.

They don't need a local Chinese bank. They have Citigroup and Hong Kong Shanghai Bank somewhere else leveraging that financial system to allocate capital to build facilities. China is saying, "We will protect your property rights in China." "But China is also telling the person on the street, "We will not protect your property rights unless you are part of the party."

Why are they doing that? Probably has some story about perpetuation of party control in there. But that is the China story. So you get a very different picture, depending on whether you are the foreign investor or you're the indigenous entrepreneur.

On the right-hand side you have a little bit of the mirror image, a little bit more messy but the mirror image, which is that India has always been—always, for the last some decades—has been very suspicious of foreign enterprise. Why is a whole separate story, but it has. It's a descriptive matter. I will say that it has a residual allergy to foreign capital. So there are still lots of barriers, still lots of procedural barriers. There are still irritants that prevent people from investing in it. It is very easy to find people complaining about loopholes, and so on.

It is not that the senior levels don't want investment to come. It is that the massive infrastructure, the bureaucratic infrastructure isn't quite on the same page as the very senior levels in terms of attracting foreign capital in. So the net result is that foreign investment is somewhat shunned. The flipside of that is that domestic enterprise is vibrant. It has run amok. The financial markets are, by emerging market standards, extremely well functioning. They really hold the entrepreneur's feet to the fire.

The equity markets in particular have seen a renaissance of the sort that you haven't seen anywhere in the world, I would say, in the last thirty years. So there is one study that says that equity markets in India have moved more in the last ten years than the U.S. markets moved in sixty years in terms of, maybe they just learned from what happened in the U.S. markets.

So that when you look at microindicators, like settlement times, or governance indicators, etc., those are pretty sharply on the ascendant. So it couldn't be more different from the China domestic situation.

And what that means is that you can graduate from the Indian Institute of Technology and you can raise money. You can now raise money if you have an idea, which is not a statement you can make for most countries around the world. You can raise money because VC [venture capital] is available, and private equity is available.

The debt side is not nearly as rosy as the equity side. The debt markets in both countries are still disastrous. But on the margin there are two or three very, very good banks in India of the sort that you don't see in China at all. So I would categorize the Chinese banking system as entirely bankrupt and the Indian banking system as a rotten core but a very robust periphery that's eating the core.

And there is a question of how quickly the periphery eats the rotten core away. The periphery is world class. There are three or four banks that have operating metrics that are every bit as good any bank that I know anywhere in the world. The only question is how quickly can they eat to get rid of the central part?

The implication of all this is that it is possible to have indigenous enterprise in the country [United States] for a good reason and a bad reason. The good reason is that it is possible to have indigenous enterprise for the same reason that we have indigenous enterprise in this country, which is that you can raise capital and property rights are somewhat protected. And the bad reason is that it is possible to have indigenous enterprise in the country because there is still a level of protectionism keeping the foreigner out. So you can interpret it whichever way you want.

But the net result is that there is an indigenous private sector. And that very indigenous private sector also lobbies the government to keep the foreigners out when it suits them. I've been in any number of meetings where the person has gone out and made a public statement in favor of foreign investment, and has proceeded to go on to the politician and lobby that person to stop that foreign investment from happening. So that is the dark side.

Just completely different models is the point. And if that's all we communicate, I think that would be sufficient. But let me take the liberty of moving ahead by one.

Challenges for Managers
So implications. I just divided this into saying, on the left you have local private companies; or you have multinationals, which are also private companies; or you have state-owned enterprises.

On the China side: Local private: Active discrimination against—by that I mean your property rights are not protected. Private enterprise until last year was not even recognized by the party as a viable thing.

Multinationals: Welcome mat laid out but the challenge of the local grabbing hand. What does that mean? That your contract might change and there really isn't the possibility of arbitration.

State-owned: The challenge you have for somebody running a state-owned enterprise is that, on the one hand, there are changing expectations for what used to be called the iron rice bowl—the idea that you had to provide all sorts of social services.

On the other hand, you know, there's a set of state-owned enterprises that are still indulged in some sense because they have free cash from an incredibly well capitalized but somewhat bankrupt banking system. What I mean is that the Chinese savings forcibly go into domestic banks. The Chinese are not allowed to take the money and invest it outside. If they were, the thing would collapse even faster. So the banks continue to get inflows but their allocations are done badly. And so they become nonperforming loans.

On the other side, India: Local private companies—what is their challenge? I would say learning to work with the government and civil society as opposed to in opposition to it. You do figure out some pressure points within the government to make it work. Like you figure out that you can outsource your satellite stuff to them. Or you figure out that you can get them to subsidize your insurance function. So very microeconomic interventions with the government. So that, to me, is the challenge there.

Multinationals are still dealing with an allergic society, a society that is allergic to foreign investment. I wish I could say otherwise but I still believe that, though it is better than ten years ago.

And state-owned: I just think it is not a good situation. State-owned companies in India: There is an attempt to try to privatize them but it keeps getting stopped and sabotaged.

Infrastructure Scorecard

Another way of repeating it in some sense—the infrastructure side. What China has is superb hard infrastructure, wonderful hard infrastructure: roads, power plants, the whole nine yards. No soft infrastructure. No property rights. No legal system. These are overstatements, again, because things are changing. Limited market for CEOs. It is very hard to go and buy and sell talent. Again, different in some parts, like the Pearl River Delta.

Risk capital I would say is still minimal, genuine risk capital.

And India is a mirror image. Roads are a mess. Power is still a mess. Phones actually are OK now because of cell phones. Another way to say it is that anything that you want to make in India, where a ratio of value added to "transportation costs" is high, you can do it because you are not that hung up about roads.

But if you want to do some mass item where ratio of value added to manufactured costs or total manufactured costs is low, it is a nonstarter in a global world, because you'll have to compete against China, which has a much more efficient cost structure, and you'll run . . . And so, predictably, there are certain kinds of—on the right-hand side it's sort of optimized. In particular, the absence of soft infrastructure doesn't matter when you are primarily catering to multinationals.

The presence of soft infrastructure helps the local private sector. And, again, this is an overstatement because there are pockets of infrastructure in the last two years that have really developed. And so you see . . .

I was on a trip to villages in China and India two or three weeks ago. And I chose the poorest . . . Here is a comparison I did, just to support your [audience member's] point. I chose one of the poorest parts of China and one of the richest parts of India for comparison, to stack it in favor of India as much as I could.

And so I went into Henan province, which is not the poorest in the sense of western China but it's the poorest in central China. And it was amazing. The roads are better than the Mass Turnpike.

And they went all the way right up to the cornfield. You drive all the way in your spanking new car and stop right at the cornfield. And you get out.

And you are in a village setting, where everything looks exactly like a village, except that it's got this state-of-the-art freeway that stops right in the middle of nowhere. It's amazing. The hard infrastructure is amazing. Now, if you can build something using that infrastructure, absolutely. That's the miracle of China. I agree with that.

In India I go to the richest, one of the richest parts, Gujarat, one of the richest states in the west of India. And I go into a village, which is hardly an hour away from one of the major cities on Ahmedabad). And it is a complete disaster, complete disaster. The road just bumps right along through the city. And you get there.

But what you do see in India is that you do see sizeable companies out in the villages: $5 million, $10 million, just popping out, mushrooming out of nowhere. You do see civil society aggregating and providing healthcare, with a bunch of self-help groups of women getting together, groups of 100 women, 200 women teaching each other education, getting technology from the Indian Institute of Technology in south India, and figuring out a way to educate illiterate people.

And in China, you don't see any of that civil society because everybody is answering to some local party official or is worried about what the party official will say. So that's what I mean. This applies as a descriptor—the urban areas and the rural areas across the board.

But I have a hard time reaching a conclusion that you do, which is, why is this better than this? I don't see that part.

For a multinational investor or an outsider, it is. For somebody within the country, it's not. And the question I pose to you is, what if we had a society in this country, in the United States, right, where we systematically told every American that, "You are not allowed to start a business. You are not allowed to do *A*, *B*, *C,* and *D*." Let's project that system a generation forward. How many of you would like that system?

So what I'm trying to communicate is that, from the standpoint of the insider, it seems like you have two options: You can be part of the state system and get benefits from it. And the good news there is that getting into the party system is sort of a meritocracy. It's that you can apply to be part of the party system. If you do well, you can become part of the party system.

It is not like there is a totalitarian despot saying, "Only my family members can be part of the party." There is free entry into the party system in some sense. You compete. And if you are good, you get to be part of the party. And that's actually a very clever device that the party uses. But if you are not part of the party, then you are out of luck in terms of individual freedoms. And the quid pro quo is that you get a cell phone [symbolically, you get some practical benefit in return].

QUESTION: One thing about labor costs. It is not cheap. China is expensive. China labor is not cheap. It is cheap only for those industries that are doing consumable products [mass market products, like consumer product].

The moment you take six years to try to take some specific European product to be manufactured in China, it is very expensive labor. But if you are trying to make televisions or refrigerators or make mobile phones, which is a mass product for a consumable market, then if you compare the labor costs with the other countries, it is less but I would not say cheaper.

PROFESSOR KHANNA: So I think the point is, the point is exactly right, which is the labor costs comparisons depend very much on the industries in question. For mass items, one of the benefits of China is that they got their education policies exactly right back in the Mao era, in some sense. So there is universal primary education, which means that you have large numbers of people who are perfectly competent to work on a factory floor.

That is not the case in India. And so that has all these attendant problems. There are many reasons for some of this. If you look at software, it's the other way around. Software professionals in India get paid more than China so the labor costs will be different. It's really an industry-specific story.

Let me address the question also that you raised of roads. I grew up very close to here, in Bombay. And the point I want to make is that, when I was a kid growing up in these skyscrapers in Bombay, right below us—and the real estate costs in these areas are like Manhattan. Think Manhattan, but think Manhattan with a fishing village right in the middle of Manhattan. Central Park. That's what this is.

And despite the efforts of everybody in that Manhattan, for twenty-five years they have not been able to move the fishing village. So when you think about why can't you build roads, this is the device I use to communicate the answer to you is that the individuals living in the fishing village have enough recourse to the courts and to the political process to basically stop you from the equivalent of eminent domain in this country.

Now this is an issue that rises in every society. When the state decides that they want to run a road through your property, there is a process that they have to go through. Sometimes it's fair. Sometimes it is not fair. The courts get involved. The media get involved. There's an adjudication process, right?

In China, by and large, if the state decides that a road is to go through your property, the road goes through your property. And these days, you see a lot of protests out in rural areas. And even if you go to Beijing or Shanghai or Guangzhou, or any of these places, you can look outside your hotel. You'll see protests on the streets sometimes, which you didn't see three years ago. But that protest never stops the state. It simple renegotiates the compensation that you get from the state.

In this case, the fishermen have actually stymied the process of being moved from Central Park in Manhattan indefinitely. So the question that you should raise is, well, why can't the rich guys living in the skyscrapers around them do something, pay someone, bribe someone, get them moved out, something, or pay these guys to relocate somewhere else? And the answer is a combination of several things.

One is that the rich guys don't vote. It is a political economy failure. They simply don't vote. The poor guys vote. And so they are the ones who keep the politicians in office. So the politician comes around and basically blocks the developer from moving there. So you can interpret it as a good side of democracy, because it's protecting the small guy. And the dark side is it is preventing physical infrastructure from happening.

So why can't you take them and relocate them into premises on the outskirts of Bombay? Well, they did that. They built all these nice buildings on the outskirts of Bombay and they moved the fishermen. The fishermen took the money, sold the property, and moved right back, which is what I would do if I were a freethinking entrepreneur in a freethinking capitalist society. And so the net result is that twenty-five years after I grew up over here, when I walk by, as I did the day before yesterday—I walked through this place—the fishing village is exactly as it was twenty-five years ago.

It is lively. There is a lot of music. There is color. There is shrimp drying. It is a wonderful setting for an anthropologist. But it is not business-friendly, per se. Right? But the point is, is that individual property rights are protected, even at the expense of aggregate development. So I'll let you make your own value judgments about how good or bad that it. But that is the description of the reality.

And in China the opposite is the case—that aggregate social advancement is prized over individual rights. And if the individual rights get trampled on the way, that's fine. So you can make your own value judgments about that also. But the net result is that when Maureen shows up, there are beautiful roads. And when I go to the village in Henan, it takes me right up to the cornfield. There are a lot of upset people along on the sides of those roads and cornfields, but we don't necessarily see them.

But if you are in the party, you're absolutely concerned about these people who are upset because you are monitoring the protests. And the protests are rising very steeply. And you have a decision question, a managerial decision as a party member. What do you do about all these protests? What can you do? The latest gimmick that I've seen, anyway, is that they've started telling the villagers that there are no taxes for agricultural produce for anything. In fact, we give you money back. I interpret it as a way of calming upset people.

But the good news of that is that the infrastructure is fantastic. And so, if you are a multinational and you want to build something that leverages that infrastructure, wonderful. You can come on in and do it. Pudong is a part of Shanghai. Amazing development, amazing, absolutely amazing. You can see the change.

Industry Mirrors Context

So industry mirrors context. Companies mirror context. One way to see this, if we look at industries—and this is a point that has come up a few times today–you look at industries that need the hard infrastructure, that need the reliable power, need the reliable roads. The ratio of value added to transportation costs is not that high. You just can't compete with China. It is not feasible in the next ten years to compete against it. Remember, there are still 100 million people coming into the cities to keep the labor costs low.

On the right-hand side, it would be very hard for China to catch up on this side, I think. These are all industries where it doesn't matter that there is no road. It is all soft assets. Now the downside of this—I want to make sure that it is not coming across as overly bullish on one or the other because that is not what I intend to say. The downside of this is that this doesn't employ a whole lot of people, on the right-hand side.

And so the vast majority of people in my country [India] are dirt poor. It's a complete, bloody disaster. It's a disaster. For all the software companies in the world, we just can't get away from the fact that India is dirt poor.

Companies Mirror Context

So same idea. I just try to think of an industry where we can make the point. On the left are companies that dominate the autos in–or at least until a couple of years ago–these are the companies that dominate the autos in China. They are all joint ventures between a multinational and a local state-owned enterprise.

On the right, it is not that these dominate the Indian auto industry, but these are indigenously designed car companies. There is a company here on the left, which I should add, which is like the indigenous ones. There are a couple of Chinese companies that have come up, too.

But one of the interesting things for us in this part of the world, the western part of the world, to think about is that these companies will come out with a $2,000 car, I don't know, in the next two years or three years. There will be a $2,000 car that is actually perfectly safe and functional and ready to go if there is no protectionism in this country or in the United Kingdom. And that has implications for everybody. And that will come out of both countries, the $2,000 car.

So the advent of a $2,000 car is wonderful news for you as a consumer. It is not so great news for you as a car producer. But as a consumer it is wonderful news. This frees up all sorts of money for others.

Same point, really quickly: companies mirror context.

These are all, as you say, soft infrastructure companies: banks, biotech companies, pharma companies, software companies.

These are all hard-asset-based companies.

Even within an industry, another example. I like this example because the traditional route to development has almost always been through the textile sector. They either go through the United States, the United Kingdom, China. Textiles is one of the first things that develop. Actually, first it is agriculture. Then the surpluses from agriculture get reinvested into light industry of which textiles is the first. The surpluses from that get reinvested into heavier industry and the country develops.

China has done that very well. It’s got an amazing garment factory.

India has disastrous garment factories. It’s not that there aren’t some that are very efficient, but the vast majority are disastrous. But even within India, within the Indian garment industry, you will see pockets of excellence. And they will be precisely where I predicted the pockets of excellence to be, which is in those sectors where the ratio of value added to transportation costs is low.

And so, the example I have there at the bottom is a company that is one of my favorite examples. It is a company in Bangalore called, awkwardly, Himatsingka Seide. *Seide* is German for “silk”—S-E-I-D-E—the silk. He has got a German name. He doesn’t have a reason why he has a German name, but he just liked the name. So he called himself Himatsingka, which is his name; *Seide* for silk. But he produces the finest tapestry silk in the world, bar none. And it is all software produced. So it has all of the state-of-the-art equipment. And when you go to a place like the palace at Versailles, that is his silk now, amazingly enough.

And if that tapestry rips, he is the guy who replaces it without your knowing it. And he gets enormous gross margins because he is the only person who can reliably reassure you that he will have that tapestry available for you indefinitely in the future and produce it for you within two days, or something extraordinary like that.

But the point is that, again, this is a business where the absence of roads is immaterial. Because the value-added is so high and it is all soft-infrastructure-based; that it doesn’t matter that there is no road outside his factory. And if you go to his factory, it is literally through the jungle. You’ve got to drive through the jungle in a Land Rover and you suddenly show up at this facility that has all the Swiss and German machines.

And occasionally he sends a shipment, which is only about this big, to some buyer somewhere in the world who really wants a super fancy tapestry and is willing to pay unbelievable amounts of money for it. And that's his business. So even within an industry the same regularity holds is the point that I'd make.

The Future

So let me say a couple of things about the future that is worth keeping in mind when you interpret the two countries. The first thing is that, because of the one-child policy in China, the ratio of working- to non-working-age population has already peaked in China. This is a serious, serious, serious problem for China: That the next twenty-five years are going to be—people often say now, the standard line has become, China is the first country in the world to become old before it becomes rich.

Every country in the world has become rich before it became old. And the fact that it was rich has allowed those countries to deal with the old. China is going to become old much before it is rich. And that is a problem, particularly for a country with no financial system, no social security. And it really, really worries the party and it should.

India is about a generation behind. So India has probably the youngest population in the world for the next twenty-five years. Why does that matter? Well, there is a debate among social scientists about the extent to which China's historic 10 percent growth rates for the last, whatever, twenty years—I don't know the numbers exactly—how much of that was actually driven by the reforms that we talk about versus by sheer demography.

To the extent that you think it was sheer demography, then a lot of that is going to go away. I don't have an answer to that but that is the thing that is being debated with no clear consensus. The Indians have been quick to start declaring a party from this and saying, "Oh, our next twenty-five years are going to be wonderful." But that is a horrible overstatement because, in order to capitalize on the demographic dividend, they need to have basic education and healthcare in place, which they don't have.

So that demographic dividend could be a demographic albatross around their neck if it is not managed correctly. And at current trends it will not be managed correctly. But, nonetheless, descriptively, that is what is going on.

The last thing I'd say is about relations between the countries. And one way I would say is that both the nation-states were created at the same time: '47 and '49 for India and China, respectively. And there was a period of mutual admiration and backslapping and saying, "Good riddance. We got rid of the colonial empire," and so on. And it quickly gave way to hostility, for a variety of reasons we don't need to go into, so that relations have been very tense for forty years.

And this has given way recently to more cooperation. When you see Tanti's [Tulsi Tanti, chairman of Suzlon Energy] company investing in China, you see Chinese companies coming into India. And that is rising very rapidly off a very small base but rising very rapidly. And I personally think that this is one of the trends that is underappreciated, particularly sitting here, because it is not immediately germane.

But think about this. In the last ten years that I've been watching emerging markets, one of the things that I think has changed is that it used to be the case that if you dreamed of building a company that had a billion dollars in sales, you could not avoid being in London or in New York. You had to go to London or New York once every two months for a meeting with investors, financiers, courts, technology, something. You had to go there to build a billion-dollar company.

Now it is very easy to build a $5 billion company and never step foot in Western Europe, Miami, New York, or anything like that. In other words, there are lots of companies that are building that have revenue bases of $3 billion, $4 billion, or $5 billion that are doing business between Brazil and China, or India and Southeast Asia, or the Middle East and Africa—lots of companies.

And think about that for a second—that the economic center of activity is moving around. And it is moving around because bits and pieces of countries are coming together to orchestrate that movement. This is just one example of that. And that's got to have some implications that I'm not smart enough to quite figure out. It's got to have some implications for everybody in some way.

And the last thing I would say is that I spent a lot of time in GE Healthcare because I like the company a lot. I think it teaches me a lot. They have been amazing about leveraging China and India—just amazing, just amazing. They have taken a very complicated—this is an example. It is not a particularly good diagram. I apologize for it. But it's a piece of machinery, ultrasound machinery, state-of-the-art ultrasound machinery.

They broke it down into 700 parts. And they have created an intercontinental supply chain of a very high-tech equipment that should make anybody blush. It just works so well. And they do the software in India and the hardware in China, the assembly in Mexico or Milwaukee or Fontainebleau or wherever else they need to. And they just move these parts seamlessly around. But I like this example because it says that this cooperation is not restricted to China and India.

Anybody can participate in it. You just have to figure out how to leverage the local context for what it is. And there are a handful of companies that are doing this very well. I would single out the Korean companies, some of the big Korean companies: Samsung, in particular, and LG. And I would single out GE as examples of companies that have figured out how to make this work like a symphony.

Thank you very much for your attention.