

# How important is foreign capital to income growth in China and India?\*\*\*

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## **Abstract**

*The picture often painted is that foreign capital inflows in China and India are prominently linked to rapid growth at the national level, and contribute to widening income disparities at the provincial/state level. In this paper we revisit Krugman's (1993) contention that foreign capital can hardly be considered an important income growth driver, when in most developing countries it only accounts for a fractional share of gross capital formation. In the case of contemporary China and India, the data suggests that Krugman's critique holds largely true, even in the coastal regions that are considered magnets for foreign investment. Thus, domestic factors, rather than the driving forces of globalization, appear to be the more important determinants of income growth in both countries.*

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## 1. INTRODUCTION

Since the 1990s, China and India have been amongst the world's fastest growing economies. In 2003, both countries grew in real terms by 9 percent. At the same time, both countries have been leading recipients of high profile foreign capital flows. In the case of China, foreign capital has predominantly flowed into the manufacturing sector and is said by many to be transforming China into a 'factory to the world'. In the case of India, it is foreign investment to the services sector, particularly IT services, that has been most prominent and an analogous tag has been used to describe India as an emerging 'back office to the world' (*The Economist*, 05/05/2001). With all the media attention devoted to foreign investment and rapid rates of income growth in both countries, it is unsurprising that the two variables are generally thought to be linked in a significant and causal manner (Venu, 2001; Secor, 2003).

A striking feature of foreign investment in both China and India is that it is strongly concentrated in particular localities. As a result, in addition to being considered a driver of income growth at the national level, foreign capital flows are also thought to be foremost amongst those factors that explain widening income disparities within both countries (Fujita and Hu, 2001; Venu, 2001; Xing and Zhang, 2004). In China and India, foreign capital has flowed overwhelmingly to the coastal provinces/states. The reasons for this are several. Most obviously, these regions hold a natural locational advantage for engaging in foreign trade and are thus, attractive hosts for trade-orientated foreign direct investment (FDI). Greatly augmenting their locational advantage is the fact that historically these provinces/states have been the leading points of embarkation for Chinese and Indian labour migration abroad. With respect to China, it is no surprise then that facing rising production costs in places such as Hong Kong and Taiwan, overseas Chinese funded the mainland's initial foreign investment boom and drew on their personal connections in the coastal regions to help negotiate their way through China's underdeveloped legal and physical infrastructure (*The Economist*, 03/05/2005). China's coastal provinces are also the richest in the country, and therefore desirable locations for domestic market-orientated foreign investment.

In the case of India, Srivastava and Sen (2003) and a recent International Monetary Fund report titled '*India: Selected Issues*' cited in Srinivasan (2005), argue that apart from Delhi, five coastal states (two each in the southern and western regions of the country, and one in the eastern region), i.e. Karnataka, Tamil Nadu, Maharashtra, Gujarat and Andhra Pradesh account for 60-70 percent of the total FDI inflows into India. These so-called high performing state economies (HPSEs), as baptized by Shand and Bhide (2001), have better infrastructure to connect with the surrounding states, a crucial factor that has helped them to be chosen as a center for the establishment of export processing zones (EPZs), and special economic zones (SEZs) for attracting export-oriented FDI. Regional FDI inflows into India have also been distinctly associated with a high degree of urbanization. For instance, all of the five coastal states mentioned above are quite highly urbanized, due to the presence of metropolitan cities like Bangalore, Chennai, Mumbai and Hyderabad (Srivastava & Sen, 2003). Thus, the stylized facts do indeed appear to point to globalization's driving forces – labour migration, trade and investment – forming a virtuous circle that strongly drives income growth. If globalization's driving forces do contribute prominently to income growth, particularly at the provincial/state level, this has broad economic and political implications. For example, spatial differences in income per capita drive internal labour migration, which in turn determines the strain that will be placed on a country's infrastructure. At least in the case of China, the authorities have also repeatedly expressed concern over the effect that regional income inequalities could have on future political stability.

In this paper we take a step back from the media hype surrounding foreign investment and economic growth in China and India, and even from many of the academic studies that report a statistically significant relationship between foreign investment and economic growth. Statistical significance is after all simply a comparison between an estimated coefficient and standard error. What really matters in terms of the impact on income growth is the *size* of the estimated coefficient. Our aim is a simple one – to consider the scale of foreign capital inflows vis-à-vis domestic capital as a source of gross capital formation. Our reflection on this issue is motivated by Krugman's (1993) observation that foreign capital generally only contributes an extremely small amount to gross capital formation in developing countries. For Krugman then, to label foreign

capital as an important income growth driver was nonsensical. The basic data analysis undertaken in this paper shows that Krugman's critique has much relevance in contemporary China and India. Domestic capital remains king, even in the coastal regions that are regarded as magnets for foreign investment. Domestic capital is also shown to be moving towards the same localities that attract the bulk of foreign capital inflows. To explain why the apparent marginal productivity of capital is higher in these areas than elsewhere, it is necessary to look beyond the driving forces of globalization and consider the impact that domestic factors have on income growth.

## **2. QUALIFYING THE LINK BETWEEN FOREIGN CAPITAL INFLOWS AND INCOME GROWTH**

In commenting on the popular view that foreign capital was an important driver of income growth in developing countries, Krugman (1993) contended that this was logically impossible when foreign capital only accounted for a fraction of gross capital formation in these countries (approximately 3 percent). He also added that he saw no good reason to expect this to change anytime soon. Levine (2001) took exception to Krugman's argument based on the fact that foreign capital might primarily contribute to income growth through its contribution to technological change and total factor productivity growth, rather than capital accumulation *per se*. Others have pointed out that the level of foreign capital flowing into developing countries continued to rise during the second half of the 1990s. Yet neither of these retorts amount to a particularly effective rebuttal of Krugman's basic argument. Firstly, even if the key contribution of foreign capital is to technological change, this effect will still be linked to its scale. Secondly, the notion that the impact of foreign capital inflows might somehow be magnified by technological spillover effects requires taking the view that foreign capital is special in this regard vis-à-vis domestic capital. We do not wish to go into this debate in detail in this paper but suffice to say the evidence on the spillover effects associated with foreign capital inflows are far from uniform (see Lipsey, 2003). Representing perhaps a more extreme view, Singh (2002) takes the position that foreign capital inflows are indeed special but more likely in a negative rather than positive way. Finally, as for the level of foreign capital inflows rising, this is not the key issue in terms of income growth. What matters is not the *level* of foreign capital inflows but their *proportional* significance.

In the 2000s, there can be little doubt that Krugman's observation has largely been forgotten amidst the excitement surrounding the rising levels of foreign capital inflows in China and India, and the changes these flows are supposed to be making to the geography of global output composition. To assess whether Krugman's critique has any relevance to contemporary China and India, Table 1 presents net inflows of foreign direct investment (FDI) and net inflows of non-FDI capital (non-FDI) (i.e., net inflows of portfolio investment + net inflows of debt) as a percentage of gross capital formation in both China and India. The chief reason to include the latter is the common complaint emanating from India that FDI comparisons between China and India are unfair, since India's more sophisticated financial institutions and direct capital markets mean that foreign capital often enters the country in non-FDI form. Table 1 contains several points of interest. Firstly, the importance of foreign capital inflows in gross capital formation is greater in China than in India.

**Table 1. Net foreign capital inflows as a percentage of gross capital formation (GCF)**

	China			India		
	Net inflows of FDI (% GCF)	Net inflows of non-FDI (% GCF)	Net foreign capital inflows (% GCF)	Net inflows of FDI (% GCF)	Net inflows of non-FDI (% GCF)	Net foreign capital inflows (% GCF)
1980	0.1	0.0	0.1	0.2	9.7	9.9
1981	0.4	2.4	2.8	0.2	6.9	7.1
1982	0.6	0.8	1.4	0.2	12.6	12.7
1983	0.8	2.8	3.7	0.0	11.8	11.8
1984	1.4	3.0	4.5	0.0	8.2	8.2
1985	1.4	4.2	5.6	0.2	7.7	7.9
1986	1.7	4.6	6.3	0.2	7.7	7.9
1987	2.4	8.4	10.8	0.4	8.3	8.7
1988	2.8	6.4	9.3	0.1	11.5	11.6
1989	2.8	3.3	6.1	0.4	8.2	8.6
1990	2.8	6.7	9.5	0.3	7.9	8.2
1991	3.3	4.2	7.6	0.1	6.3	6.4
1992	7.4	9.9	17.3	0.5	8.5	9.0
1993	14.7	8.3	23.0	0.9	5.6	6.5
1994	15.1	6.5	21.6	1.3	9.8	11.1
1995	12.5	6.4	18.9	2.3	0.9	3.2
1996	12.4	4.9	17.3	2.9	5.6	8.5
1997	12.9	7.0	19.9	3.9	1.0	4.9
1998	12.3	-3.8	8.5	3.0	2.8	5.7
1999	10.4	-0.3	10.2	2.1	1.1	3.2
2000	9.8	0.4	10.2	2.4	5.6	8.0
2001	9.8	0.2	10.0	3.5	1.0	4.5
2002	9.6	0.6	10.2	3.2	0.1	3.3
2003	8.5	3.4	11.9	3.1	2.7	5.8
<i>Ave 80-03</i>	<i>6.5</i>	<i>3.8</i>	<i>10.3</i>	<i>1.3</i>	<i>6.3</i>	<i>7.6</i>
<i>Ave 80-89</i>	<i>1.4</i>	<i>3.6</i>	<i>5.1</i>	<i>0.2</i>	<i>9.2</i>	<i>9.4</i>
<i>Ave 90-99</i>	<i>10.4</i>	<i>5.0</i>	<i>15.4</i>	<i>1.7</i>	<i>4.9</i>	<i>6.7</i>
<i>Ave 00-03</i>	<i>9.4</i>	<i>1.1</i>	<i>10.6</i>	<i>3.0</i>	<i>2.4</i>	<i>5.4</i>

Source – World Bank, World Development Indicators Database and Global Development Finance Database.

A higher share in China has been particularly pronounced since the 1990. Secondly, FDI accounts for a larger proportion of foreign capital inflows in China compared with India. This may augment the impact that foreign capital has on income growth in China compared with India if one regards FDI as embodying favorable characteristics (such as more advanced technology) that are not found in debt and portfolio investment flows. Thirdly, while the importance of foreign capital in China and

India's capital formation exceeds that of Krugman's 'average' developing country, even in the case of China, it remains relatively modest averaging 10.3 percent of the entire period. The danger of too closely linking high rates of economic growth to foreign capital inflows is starkly illustrated by China's experience during the 1980s. China began its economic reform program in 1979 and almost immediately the growth rate jumped to average nearly 10 percent during 1980s. Yet during the 1980s, foreign capital inflows accounted for just 5.1 percent of gross capital formation. Finally, it is interesting to consider the changing importance of foreign capital in each country over time. While the hype surrounding foreign capital inflows in both countries has become more fever-pitched during the 2000s, the contribution that these inflows have made to gross capital formation has actually fallen. In China, the contribution fell from 15.4 percent during the 1990s to 10.6 percent in the 2000s. A decline from the 1990s to the 2000s is also observable in the case of India although the drop is not as pronounced as in China. A major difference between the two countries on the other hand is how the importance of foreign capital changed after economic reform programs began. In China, while the importance of foreign capital declined in the 2000s compared with the 1990s, it remained significantly higher than in the early stages of the reform program during the 1980s. In India, foreign capital inflows actually contributed more significantly to gross capital formation *before* economic reforms began in 1991. During the 1980s, foreign capital inflows accounted for 9.4 percent of gross capital formation. In the 1990s this fell to 6.7 percent and in the 2000s to 5.4 percent. One feature that has positively responded to economic reform in India is the proportion of foreign capital inflows in the form of FDI. Nevertheless, with the importance of foreign capital inflows so marginal overall, it remains somewhat counter-intuitive to link recent high rates of income growth with foreign capital inflows.

To assess whether foreign capital is relevant in explaining divergences in the spatial distribution of income within China and India, it is necessary to assemble provincial/state-level data. In Tables 2 and 3 we use sub-national level data from China and India to calculate in the case of China, the share of actually used foreign investment as a percentage of gross capital formation in each province, and with respect to India, the share of FDI approvals as a percentage of gross capital formation

in each of the major states. Two findings stand out. Firstly, in China foreign capital clearly contributes more significantly to gross capital formation in the coastal eastern provinces than in the central and western regions. Surprisingly however, in India, FDI contributes more extensively to gross capital formation in the middle-income states than in the high and low-income states. This can be attributed to the fact that the Indian central government to date has played a limited role in promoting the investment climates of the states. Rather, it is up to each state to try to attract more foreign investment. Secondly, in spite of its relative significance in some provinces compared with others, even in the case of the former, foreign capital does not come close to rivaling domestic capital in terms of its importance. On average, foreign capital only accounts for 12.4 percent of gross capital formation in the eastern provinces of China and 9.6 percent in the middle-income states of India. Admittedly though, there is considerable variation amongst the Chinese eastern provinces and middle-income Indian states. In Guangdong province in China, for example, the share of foreign capital reaches nearly one quarter. Nonetheless, on the whole it would be difficult to construct the argument that foreign capital flows are a key factor driving income growth at both the national and provincial/state levels in China and India.

**Table 2. Foreign investment in China as a percentage of gross capital formation, average 2001-2003**

Eastern provinces		Central provinces		Western provinces	
Beijing	7.8	Anhui	2.0	Chongqing	2.0
Fujian	19.2	Heilongjiang	2.3	Gansu	0.9
Guangdong	23.9	Henan	1.5	Guizhou	0.5
Guangxi	3.8	Hubei	6.6	Ningxia	0.6
Hainan	13.9	Hunan	4.8	Qinghai	1.3
Hebei	2.5	Inner Mongolia	1.2	Shaanxi	2.5
Jiangsu	17.3	Jiangxi	5.2	Sichuan	2.2
Lioning	12.7	Jilin	2.4	Tibet	N/a
Shandong	10.2	Shanxi	1.9	Yunnan	0.7
Shanghai	12.7			Xinjiang	0.2
Tianjin	13.6				
Zhejiang	11.5				
<i>Average</i>	<i>12.4</i>		<i>3.1</i>		<i>1.2</i>

Source – China Statistical Yearbook.

**Table 3. Foreign investment approvals in India as a percentage of gross capital formation, average 1991-2001**

High-income states		Middle-income states		Low-income states	
Punjab	3.1	Kerala	1.9	Bihar	1.2
Gujarat	8.2	Andhra Pradesh	9.4	Rajasthan	2.8
Maharashtra	12.4	Karnataka	14.2	Uttar Pradesh	2.0
Haryana	4.8	Tamil Nadu	13.1	Madhya Pradesh	1.9
Delhi	N/a	West Bengal	9.5	Orissa	14.1
				Assam	N/a
Average	7.1		9.6		4.4

Source – Lakhchaura (2004) and Singh and Srinivasan (2004).

Endogeneity issues generally infect the reliability of econometric studies that consider the impact of foreign capital inflows on income growth. In the case of China, Zhang and Zhang (2003) is perhaps the most instructive econometric study to emerge to date and at least attempted to take the endogeneity issue into account. Using provincial level data, they find in common with most previous studies that there exists a statistically significant relationship between the foreign capital stock and labour productivity. However, the more telling feature of their study in terms of the impact on income growth was the fact that the size of the estimated coefficient associated with the domestic capital stock was *15 times larger* than that associated with the foreign capital *stock*. Such results follow logically from the *flow* FDI data presented in Tables 1 and 2. Zhang and Zhang (2003) also draw on their econometric findings to explain the contributions that the domestic capital stock and the foreign capital stock (along with other variables) made to observed divergences in spatial income inequalities between 1986-1998. They conclude that the contribution of the domestic capital stock was 75.1 percent, compared with just 11.1 percent for the foreign capital stock.

Amongst India's states, Maharashtra has been by far and away the standout performer in terms of attracting FDI, attracting more than double that of its closest rivals, Tamil Nadu, Karnataka, Gujarat, Delhi and Andhra Pradesh. Yet even for Maharashtra, between 1991-2001, FDI only accounted for 12.4 percent of the state's gross fixed capital formation. The fractional share of foreign investment in gross capital formation across Indian states helps to explain why some states can be relatively rich

while capturing only a fraction of the national foreign investment total. Punjab, Haryana, Kerala and West Bengal, for example, are considered to be middle to high-income states, yet collectively they only account for 5.9 percent of national FDI approvals (Mahendra Dev, 2004). Foreign investment, in aggregate, simply does not matter much. The above numbers also mean that the results of econometric studies by Dua and Rashid (1998), and Chakraborty and Basu (2002) who report no statistically detectible, causal relationship running from FDI to economic activity in the case of India are unsurprising.

Another feature of the data is that it shows domestic capital in China and India also moves to particular localities. Table 4 shows that gross capital formation per capita in China's eastern provinces in 2003 was more than twice that in the central and western provinces. This was in spite of the central government's 'Go West' campaign, which sought to reallocate domestic capital toward the inland regions through budgetary means and directed credit, as well as through establishing a host of incentives to lure foreign capital. Table 5 also demonstrates a similar trend with regards to India, with the high-income states in 2000 accumulating gross capital formation per capita that is almost double that of the middle-income states, and more than 3 times the amount in the low-income states. The fact that both domestic and foreign capital moves to the same localities strongly suggests that the marginal productivity of capital in these regions is higher than elsewhere. Given its limited scale, and the theoretical ambiguity surrounding the broader productivity impact that foreign capital inflows might have, in the following section we argue the need to look elsewhere to explain these spatial divergences in capital productivity.

**Table 4. Gross capital formation (RMB) per capita, 2003**

Eastern provinces		Central provinces		Western provinces	
Beijing	15,751	Anhui	2,270	Chongqing	4,199
Fujian	6,872	Heilongjiang	3,428	Gansu	2,346
Guangdong	6,612	Henan	2,974	Guizhou	1,963
Guangxi	2,121	Hubei	3,569	Ningxia	5,522
Hainan	3,895	Hunan	2,609	Qinghai	5,512
Hebei	4,622	Inner Mongolia	5,460	Shaanxi	3,712
Jiangsu	8,348	Jiangxi	3,185	Sichuan	2,638
Lioning	5,543	Jilin	4,079	Tibet	3,871
Shandong	6,344	Shanxi	3,712	Yunnan	2,622
Shanghai	17,283			Xinjiang	5,787
Tianjin	13,057				
Zhejiang	9,913				
<i>Average</i>	<i>8,363</i>		<i>3,477</i>		<i>3,817</i>

Source – China Statistical Yearbook.

**Table 5. Gross capital formation (Rs.) per capita, 2000**

High-income states		Middle-income states		Low-income states	
Punjab	4,130	Kerala	4,056	Bihar	1,439
Gujarat	8,179	Andhra Pradesh	3,437	Uttar Pradesh	2,250
Maharashtra	6,454	Karnataka	5,363	Madhya Pradesh	3,506
Haryana	6,203	Tamil Nadu	4,821	Rajasthan	3,085
Delhi	7,616	West Bengal	1,635	Orissa	1,783
				Assam	899
<i>Average</i>	<i>6,516</i>		<i>3,862</i>		<i>2,160</i>

Source – Lakhchaura (2004) and Singh and Srinivasan (2004).

### 3. CONCLUDING COMMENTS

The purpose of this paper was a simple one – to take a step back from the conventional wisdom that closely links foreign investment and income and consider the scale of foreign capital inflows vis-à-vis domestic capital as a source of gross capital formation. This reflection was motivated by Krugman's (1993) critique that foreign capital is generally unimportant as a source of capital formation in developing countries. Despite the high profile accorded to China and India as hosts of foreign investment, we find that foreign capital inflows usually only equate to a small share of gross capital formation in both countries. We do not mean to suggest that foreign capital inflows are somehow irrelevant. To the extent that foreign capital supports a faster rate of capital accumulation and / or exhibits spillover effects over and above

those associated with domestic capital, then national and regional income growth rates will be impacted upon. Our point is simply that the scale of foreign capital inflows remains fundamental in determining its impact on income growth and correlation and statistical significance need not imply causality or a sizeable real world impact.

For us, a particularly important stylized fact that requires explanation is the apparently large regional variations in the marginal productivity of capital within both China and India. We leave providing a detailed commentary on the reasons for such spatial variations to others but the limited proportional significance of foreign capital inflows in gross capital formation leads us to conclude the chief answer is unlikely to lie here. There is good reason to speculate that the importance of trade to the regional economy is a far more important factor. The static and dynamic gains from trade are well known and trade does account for a large share of regional GDP in China and India's coastal provinces. For example, in China in Guangdong province and the municipality of Shanghai, trade accounted for 190 and 150 percent of GDP respectively in 2003. There is of course interplay between foreign capital and trade. In China, companies with some foreign funding now account for more than 50 percent of the country's total exports. We speculate that it is through this indirect channel that foreign capital inflows may have their largest impact on income growth. Yet even the trade-FDI nexus needs to be treated carefully. It is, for example, often unappreciated that the majority of FDI moving into China is in fact orientated towards supplying the domestic market. Buckley and Meng (2005) show this holds true even in the case of the manufacturing sector, which is the nation's star export performer, accounting for 92 percent of China's total exports in 2003.

Beyond trade, a host of domestic factors strike us as being far more relevant than the driving forces of globalization. In the case of China, one key issue is deficiencies associated with the fiscal system in performing its redistributive function, which impacts on the provision of physical infrastructure and human capital development at the local level (OECD, 2004). There are also question marks over the relative efficiency of local government institutions (an issue encountered in India as well), and the impact of central government policies that favour some regions over others (Brown, et al., 2005). China's domestic market also remains quite fragmented with

wide-ranging differences in the degree of marketisation between the provinces (Fan, et al., 2001). In India's case, low quality infrastructure remains the main concern, with infrastructure in most states in need of considerable upgrading. Other factors include the absence of jointly coordinated policies by both the central and state governments towards enhancing the productivity of capital, an inflexible labour market due to stringent labour laws, limited scale of export processing zones, corruption, and the significant burden of bureaucratic red tape and regulation (Rao, 2004; Srinivasan, 2005). Given the practical conundrums that spatial variations in income growth engender, it is a matter of importance that research and policy attention is focused on key issues. The analysis undertaken in this paper suggests it would be wise not to become overly fixated on the impact of globalization.

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