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Justin Yifu Lin^a

^a National School of Development, Peking University, Beijing, China

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The Washington Consensus revisited: a new structural economics perspective

Justin Yifu Lin*

National School of Development, Peking University, Beijing, China

The Washington Consensus reform resulted in economic collapse and stagnation in many transition economies and “lost decades” in other developing countries in 1980s and 1990s. The paper provides a new structural economics perspective of such failures. The Washington Consensus reform failed to recognize that many firms in a transition economy were not viable in an open, competitive market because those industries went against the comparative advantages determined by the economy’s endowment structure. Their survival relied on the government’s protections and subsidies through various interventions and distortions. The Washington Consensus advised the government to focus their reforms on issues related to property rights, corporate governance, government interventions, and other issues that may obstruct a firm’s normal management. Without resolving the firms’ viability problem, such reforms led to the firms’ collapse and an unintended decline and stagnation of the economy in the transition process. This paper suggests that the viability assumption in neoclassical economics be relaxed when analyzing development and transition issues in socialist, transition, and developing economies.

Keywords: industrial policy; economic development; comparative economic systems; transition economics

JEL Classification: L5, O1, P5

1. Introduction

Since the late 1970s, China and other socialist countries began the transition from a planned economy to a market economy in order to improve their economic performance. Figure 1 shows that such a transition brought about rapid economic growth in China and Vietnam from the very beginning. The transitions that began in the early 1990s in the former Soviet Union and Eastern European countries (FSUEE hereafter), however, led to dramatic declines in their economies and deterioration in most aspects of social development (World Bank 2002; Dell’Anno and Villa 2013). A survey conducted in 2006 by the European Bank for Reconstruction and Development and the World Bank of 29,000 people in 29 countries – including Eastern and Southeastern Europe, the Baltic states, the Commonwealth of Independent States, and Mongolia – found that only 30% believed their lives were better than in 1989 (EBRD 2007). According to EBRD’s transition indicators, many transition economies in FSUEE had become “stuck in transition”: price liberalization, small-scale privatization, and the opening up of trade and foreign exchange markets were mostly complete by the end of the 1990s. However, economic reform had slowed in areas such as governance,

*Email: justinlin@ccer.pku.edu.cn

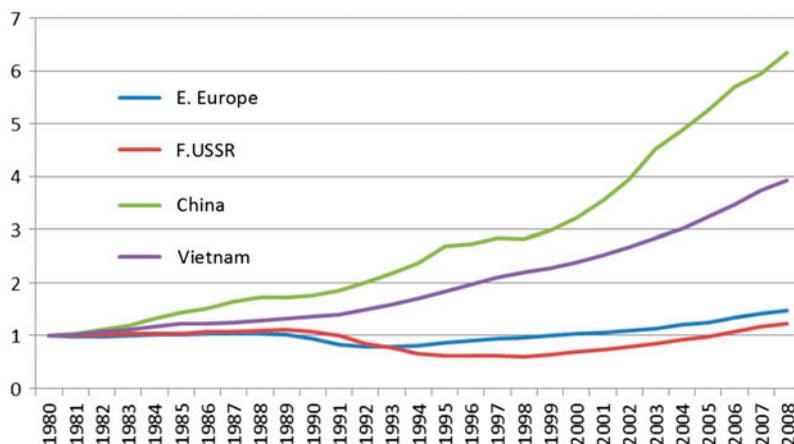


Figure 1. Transition performance.

enterprise restructuring, and competition policy, which remained substantially below the standard of other developed market economies (EBRD 2013). During the same period, most developing countries in other parts of the world followed the advice of the International Monetary Fund (IMF) and the World Bank to implement reforms to reduce government intervention and enhance the role of the market. The result was, however, also disappointing. The economic performance of the most developing countries deteriorated during this period (Barro 1998). Easterly (2001) referred the 1980s and 1990s as the lost decades for the developing countries.

Such a contrasting transition results in East Asia and in Eastern Europe and Former Soviet Union are unexpected by economists. Economic profession is known to have diverse views on practically all issues, however, as Summers (1994, 252–253) wrote, when it comes to reforming a socialist economy, there is a surprising consensus among mainstream economists for adopting shock therapy based on the Washington Consensus.¹ Washington Consensus was a term coined by Williamson (1989), originally referring to a policy package recommended to crisis-hit Latin American countries.² The main idea of the Washington Consensus was to eliminate government interventions and distortions so as to create a private property-based efficient, open, competitive market economy. The shock therapy that was promoted to Eastern Europe and the former Soviet Union for their transition to a market economy was a version of the Washington Consensus.

One element of the shock therapy is the need for rapid privatization. Arguments in support of this are as follows: private ownership is the foundation for a well-functioning market system; real market competition requires a real private sector (Sachs and Lipton 1990); most problems encountered by state-owned enterprises (SOEs) in a transitional economy can be ameliorated by rapid privatization (Sachs 1992); and privatization must take place before SOEs can be restructured (Blanchard et al. 1991).³ Another early consensus view for transition is the need for a total big bang price liberalization. An influential article by Murphy, Schleifer, and Vishny (1992) attributed the fall in outputs in the Soviet Union in 1990–1991 to partial price liberalization. They argued that a dual-track pricing system encouraged arbitrage, corruption, rent seeking, and diversion of scarce inputs from high-value to low-value use. The last element in shock

therapy is the need to tighten a government's fiscal discipline to maintain macroeconomic stability so that prices can serve as a guide for resource allocation and market mechanism can work well.

China was one of the first among the socialist countries to transit from a planned economy to a market economy. In the 12 years from 1978 to 1990, the transition in China generated remarkable achievements, with the country's GDP growing 9.0% annually and its trade volume growing at 15.4% per year. During this period, urban per capita income grew 5.9% annually, while that of rural areas grew at a spectacular rate of 9.9% annually (NBS 2002, 17, 94, 148). Living standards in China increased significantly and disparities between urban and rural areas decreased. However, China did not adopt the shock therapy, instead it adopted a gradual approach in its transition. Its SOEs were not privatized; a dual-track resource allocation system was prevalent with state planning still playing a very important role alongside markets in resource allocation. Many economists at that time thought that although China's economic transition was blessed with beneficial initial conditions,⁴ the dual-track system would soon lead to efficiency loss, rent-seeking, and institutionalized state-opportunism (Qian and Xu 1993; Woo 1993; Balcerowicz 1994; Sachs and Woo 1994, 2000). Some economists even claimed that, despite its initial success, China's dual-track approach to the economic transition would eventually lead the economy to a disastrous collapse (Murphy, Schleifer, and Vishny 1992; Sachs, Woo, and Yang 2000).⁵ Instead of collapse, Chinese economy not only withstood the shocks and contributed to the quick recoveries of East Asian financial crisis in the late 1990s and the recent global financial crisis but also accelerated its average GDP growth rate from 9.0% annually in 1979–1990 to 10.3% in 1991–2012 (Lin 2012b; NBS 2013).

In contrast, most economists in the early 1990s were optimistic about the transition in the FSUEE due to the fact that their transition followed the shock therapy recommended by the mainstream economists (Lipton and Sachs 1990; Blanchard et al. 1991; Boycko, Shleifer, and Vishny 1995). Economists recommending shock therapy also knew the transition from one economic system to another took time and that it was costly to cast aside vested interests. Nevertheless, they optimistically predicted that the economies would grow after six months or a year following an initial downturn resulting from implementation of the shock therapy (Kornai 1990; Lipton and Sachs 1990; Brada and King 1991; Wiles 1995). According to their arguments, the FSUEE would soon outperform China, even though the former had instituted their reforms much later. Nevertheless, such prediction has never been realized.⁶

In the 10 years after the transition started, the countries that implemented shock therapy experienced serious inflation and economic decline. Russia's inflation rate reached 163% per year, while Ukraine's reached 244% per year in 1991–2000. The cumulative output decline in countries in Central and Southeastern Europe and the Baltics reached 22.6%; in countries of the Commonwealth of Independent States output fell 50.5%. In 2000, Russia's GDP was only 64% of what it had been in 1990, while in Poland, the best performing economy in the FSUEE, GDP increased only 44%, compared with 1990.⁷ Meanwhile, the Gini coefficient of income per capita, a measurement of income disparity, increased from 0.23 in 1987–1990 to 0.33 in 1996–1998 in countries of Central and Southeastern Europe and the Baltics, and from 0.28 to 0.46 in countries of the Commonwealth of Independent States (World Bank 2002). Overall, as summarized by Campos and Coricelli (2002), the countries that implemented shock therapy experienced great difficulties in their reforms, demonstrated in the seven

stylized facts: output fell, capital shrank, labor moved, trade reoriented, structure changed, institutions collapsed and transition costs.⁸

Why then were most economists not optimistic about China's future performance in the early 1990s in spite of its impressive performance of its first 10 years of transition? Many economists, who participated in the FSUEE reforms, work at the frontiers of economic research and are considered masters of modern economics. Why couldn't they predict and explain the difficulties brought about by shock therapy based on the Washington Consensus, and why, at the same time, were they pessimistic about China's approach to transition? A rethinking of the existing economic transition theories is in order. In this paper, I will provide a new structural economics analysis of the reasons for the inadequacy of using Washington Consensus as a policy framework for economic transition. This paper is organized as follows: Part II introduces the main ideas of the new structural economics; part III defines the concept of viability and points out that most firms in transition economies in fact were nonviable due to their governments' adoption of comparative advantage-defying development strategies before the transition and the government's interventions and distortions were endogenous to the needs of protect and subsidize the nonviable firms. Part IV explains why the Washington Consensus reforms led to severe economic difficulties and China's dual-track gradual approach to transition achieved stability and dynamic growth in the transition process. Part V concludes with a suggestion for incorporating the viability concept in the neoclassical analysis.

2. The new structural economics

The new structural economics is an application of neoclassical approach to study the determinants of economic structure and causes of its transformation over time in the process of economic development and transition in a country (Lin 2011, 2012a).⁹ It starts with the observation that the nature of modern economic development is a process of continuous structural change in technologies, industries and hard and soft infrastructure, which makes possible the continuous increase in labor productivity and thus per capita income in an economy. The optimal industrial structure in an economy at a specific time, that is, the industrial structure that makes the economy most competitive domestically and internationally at that specific time, is endogenous to its comparative advantage, which in turn is determined by the economy's given endowment structure at that time.¹⁰ Economies that try to grow simply by adding more and more physical capital or labor to the existing industries eventually run into diminishing returns; and economies that try to deviate from their comparative advantage in their industrial upgrading are likely to perform poorly because firms in the new industries will be nonviable in an open, competitive market and their survival requires their governments' subsidies and protections, often through various distortions and interventions in the market (Lin 2009).

Because the optimal industrial structure at any given time is endogenous to the existing factor endowments, a country trying to move up the ladder of technological development must first change its endowment structure. With capital accumulation, the economy's factor endowment structure evolves, pushing its industrial structure to deviate from the optimal determined by its previous level. Firms then need to upgrade their industries and technologies accordingly in order to maintain market competitiveness.

If the economy follows its comparative advantage in the development of its industries, its industries will have the lowest possible factor costs of production and thus be

most competitive in domestic and world markets.¹¹ As a result, they will gain the largest possible market share and generate potentially the largest surplus. Capital investment will also have the largest possible return. Consequently, households will have the highest savings propensity, resulting in an even faster upgrade of the country's endowment structure.

A developing country that follows its comparative advantage to develop its industries can also benefit from the advantage of backwardness in the upgrading process and grow faster than advanced countries. Enterprises in developing countries can benefit from the industrial and technological gap with developed countries by acquiring industrial and technological innovations that are consistent with their new comparative advantage through learning and borrowing from developed countries.

The main question then is how to ensure that the economy grows in a manner that is consistent with its comparative advantage determined by its endowment structure. The goal of most firms everywhere is profit maximization, which is, *ceteris paribus*, a function of relative prices of factor inputs. The criterion they use to select their industries and technology is typically the relative prices of capital, labor, and natural resources. Therefore, the precondition for firms to follow the comparative advantage of the economy in their choice of technologies and industries is to have a relative price system which can reflect the relative scarcity of these production factors in the endowment structure. Such a relative price system exists only in a competitive market system. In developing countries where this is usually not the case, it is necessary that government action be taken to improve various market institutions so as to create and protect effective competition in the product and factor markets.

In the process of industrial upgrading, firms need to have information about production technologies and product markets. If information is not freely available, each firm will need to invest resources to collect and analyze it. First movers who attempt to enter new industries can either fail – because they target the wrong industries – or succeed – because the industry is consistent with the country's new comparative advantage. In case of success, their experience offers valuable and free information to other prospective entrants. They will not have monopoly rent because of competition from new entry. Moreover, these first movers often need to devote resources to train workers on the new business processes and techniques, who may be then hired by competitors. First, movers generate demand for new activities and human capital which may not have existed otherwise. Even in situations where they fail, their bad experience also provides useful knowledge to other firms. Yet, they must bear the costs of failure. In other words, the social value of the first movers' investments is usually much larger than their private value and there is an asymmetry between the first movers' gain from success and the cost of failure. Successful industrial upgrading in an economy also requires new types of financial, legal, and other "soft" (or intangible) and "hard" (or tangible) infrastructure to facilitate production and market transactions and allow the economy to reach its production possibility frontier. The improvement of the hard and soft infrastructure requires coordination beyond individual firms' decisions.

Economic development is therefore a dynamic process marked with externalities and requiring coordination. While the market is a necessary basic mechanism for effective resource allocation at each given stage of development, governments must play a proactive, enabling role to facilitate an economy to move from one stage to another. They must intervene to allow markets to function properly. They can do so by (i) providing information about new industries that are consistent with the new comparative advantage determined by change in the economy's endowment structure;

(ii) coordinating investments in related industries and the required improvements in infrastructure; (iii) subsidizing activities with externalities in the process of industrial upgrading and structural change; and (iv) catalyzing the development of new industries by incubation or by attracting foreign direct investment to overcome the deficits in social capital and other intangible constraints.

In sum, the new structural economics framework is three-pronged: it includes a recognition of differences in the optimal industrial structure for countries in different stages of development due to the differences in comparative advantage defined by their endowment structures; reliance on the market as the optimal resource allocation mechanism at any given stage of development; and the acknowledgement of a facilitating role played by an enabling state in the process of industrial upgrading and structural transformation. It helps explain the economic performance of the most successful developing countries.

3. Viability, development strategy, and the endogenous nature of distortions in a transition economy

The key characteristics of the endowment structure in developing countries are a relative abundance of natural resources or unskilled labor and a scarcity of human and physical capital. Based on the new structural economics analysis, developing countries with abundant unskilled labor or resources but scarce human and physical capital will have comparative advantages in the labor-intensive and/or resource-intensive industries in open, competitive markets; and developed countries with abundant capital and relatively scarce labor will have comparative advantages and be competitive in capital-intensive industries. The development strategy in socialist countries and that advocated by the dominant development thinking – the structuralism in the 1950s and 1960s and pursued by governments in many developing countries after World War II advised the governments in socialist and developing countries to develop the capital-intensive industries prevailed in advanced countries (Lin 2011). Such a development strategy in essence was a comparative advantage-defying (CAD) strategy (Lin 2003, 2009).

Under a CAD strategy, firms in prioritized industries are not viable in an open, competitive market. Even if they are well managed, they cannot earn a socially acceptable profit.¹² Unless the government provides subsidies and/or protection, no one will invest in or continue to operate such firms. The lack of capital-intensive industries in developing countries is not, therefore, due to market rigidity, as the structuralism claimed, but due to the nonviability of the firms in an open, competitive market.¹³

In order to implement a CAD strategy, the socialist government and other developing country's governments as well had to subsidize numerous nonviable enterprises. Due to limited tax-collection capacities, the governments had to resort to administrative measures – granting the nonviable enterprises in prioritized industries subsidies/protections through monopoly, repressing interest rates,¹⁴ over-valuing domestic currency, and lowering raw materials prices. Such interventions inevitably caused widespread shortages in funds, foreign exchanges, and raw materials. The government, therefore, needed to allocate these resources directly to these enterprises through administrative channels, including national planning in the socialist countries and credit rationing, investment, and entry licensing in nonsocialist developing countries.¹⁵

Although with the above administrative measures when a developing country built up industries defying the comparative advantages, serious information problems arose. It was impossible for the government to determine the necessary amount of protection

and subsidies. When an enterprise incurred a loss, – even if it was due to mismanagement or moral hazard problems – the blame would fall on the government for insufficient protection and subsidies, and the enterprise would use this as an excuse to ask for even more protection and subsidies, causing the soft budget constraint problems (Lin and Tan 1999)¹⁶ and rent-seeking behavior (Krueger 1974). To reduce incentives for rent-seeking, the governments in all socialist countries and many other developing countries nationalized the firms in priority industries (Lin, Cai, and Li 2001; Lin and Li 2008).

The CAD strategy might also prevent a developing country to benefit from the advantage of backwardness due to patent protections and embargoes on advanced technology from developed countries. Because the limited available capital resources were used to develop prioritized capital-intensive industries, labor-intensive industries that were consistent with the economy's comparative advantages could not receive sufficient financial supports and their development was repressed. With an overall poor economic performance, the ability to carry out expensive and risky indigenous technological research and development would be limited. After a few years, these once advanced industries in the priority sector became obsolete. As a result, the technology gap with developed countries soon widened.

A CAD strategy would also affect income distribution. In socialist countries that had eliminated capitalists, the development of prioritized industries could be realized through direct government investment, accompanied by suppression and equalization of wage rates through administrative measures. The equality was artificial. In other market-based countries, income distribution would be polarized (Lin and Chen 2007; Lin and Liu 2008). In those countries, only wealthy and/or crony capitalists, who had intimate relationships with the government and opportunities to access bank loans and fiscal resources, had the ability to invest in prioritized capital-intensive industries. Subsidies to prioritized industries had to come from those workers and peasants who were relatively poor and unable to invest in the priority industries through direct or indirect taxations. Therefore, the adoption of a CAD strategy inevitably polarized income distribution. Meanwhile, because the prioritized industries were capital intensive, they generated only limited employment opportunities. The labor-intensive industries that could generate more employment opportunities could not develop fully due to the lack of capital. Large numbers of laborers were either retained in rural areas or became unemployed or semi-employed. As such, the wage rate was repressed. Therefore, even if a fast investment-led growth was achieved at the beginning, the poor would not benefit from the growth (Lal and Myint 1996).

In summary, while the adoption of a CAD strategy could establish some advanced industries in the socialist and developing countries, it inevitably led to inefficient resource allocation, suppressed working incentives, rampant rent-seeking behavior, deteriorating income distribution, and poor economic performance. In the end, the adoption of a CAD strategy would not narrow the gap between developing and developed countries; instead, the gap would become wider and wider.¹⁷ The poor performance thus called for reforms in the economy and a transition from the government-led, planned economy to a market economy.

Since many existing firms in socialist and transition economies were not viable, it is not surprising that existing neoclassical economic theories, with its implicit viability assumption, are not adequate for addressing problems in socialist and transition economies. If the problem of nonviability is not eliminated, and if the government is unwilling or unable to let the nonviable firms go bankrupt, eliminating distortions and

reforming institutional arrangements according to the existing neoclassical economic theories are likely to turn the arrangements from the second best to the third best. Therefore, the reforms at best will not achieve the intended effects and at worst will exacerbate the situation.

4. Viability and the failure of Washington Consensus

Why did the Washington Consensus reforms cause economic decline, stagnation, and frequent crises in many transition economies in FSUEE and many other developing countries? What went wrong was not the goal of setting up an open, competitive market system but the failure to recognize the endogenous nature of the distortions in the economic system before transition.

The objectives of the Washington Consensus reforms were to eliminate government distortions and interventions in socialist and developing countries, and to set up a well-functioning market system. If this goal were realized, market competition would determine the relative prices of various products and production factors, and relative prices would reflect their relative scarcities in factor endowments. Given these prices, market competition would induce enterprises to choose industries, products, and technology that were consistent with the comparative advantages determined by the economy's endowment structure. Consequently, the economy would be able to make full utilization of the advantage of backwardness, and would prosper.

Nevertheless, there existed many nonviable enterprises in transition economies. Without government protection and subsidies, those enterprises were unable to survive in an open and competitive market. If there were only a limited number of such non-viable enterprises, the output value and employment of those enterprises would be limited; shock therapy that eliminated all government interventions at once might be applicable. With the abolition of government protection and subsidies, these nonviable enterprises would become bankrupt. However, the originally suppressed labor-intensive industries would thrive, and newly created employment opportunities in these industries could surpass the losses from the bankruptcy of nonviable firms. As a result, the economy could grow dynamically soon after implementing the shock therapy, with at most a small loss of output and employment initially.

On the other hand, if the number of nonviable firms was large, the output value and employment of those firms would make up a large share of the national economy. Shock therapy might result in economic chaos due to large-scale bankruptcies and dramatic increases in unemployment. In order to avoid such consequences or to sustain these 'advanced' nonviable enterprises for national security or pride, the government had no choice but to continue its protection and subsidies for these firms often in a more disguised way than the previous distortions: that is, changing the previous second best distortions to even worse third or fourth best distortions. Even if the firms were privatized, soft budget constraint problems would continue. The subsidies to the nonviable firms could even increase due to the private owners having greater incentives to lobby for subsidies and protection (Lin and Li 2008). In effect, this was what happened in Russia and many other countries in Eastern Europe and the former Soviet Union (Pleskovic 1994; Lavigne 1995; Brada 1996; Frydman, Gary, and Rapaczynski 1996; Stark 1996; Sun 1997; World Bank 2002). In the end, the economy could find itself in an awkward situation of shock without therapy (Kolodko 2000; Galbraith 2002).¹⁸

Facing the endogenously formed distortions and the existence of large-scale nonviable enterprises in the economy, the dual-track gradual approach adopted by the Chinese

government is arguably better than shock therapy (McKinnon 1993; Lau, Qian, and Roland 2000). Instead of removing all subsidies immediately proposed by the Washington Consensus, the Chinese government adopted measures to improve incentives for farmers and SOE workers while retaining transition subsidies to SOEs in the priority industries; it adopted the individual household-based farming system to replace the collective farming system,¹⁹ and introduced profit-retention and managerial autonomy to SOEs,²⁰ making farmers and workers partial residual claimants. This reform greatly improved the incentives and productivity in agriculture and industry (Jefferson, Rawski, and Zheng 1992; Lin 1992; Grove et al. 1994; Weitzman and Xu 1994; Jefferson and Rawski 1995; Li 1997). Then the government allowed collective township-and-village enterprises (TVEs)²¹, private enterprises, joint ventures, and SOEs to use the resources under their control to invest in labor-intensive industries that had been suppressed in the past. Meanwhile, the government required farmers and SOEs to fulfill their obligations to deliver certain quotas of products to the State at pre-set prices. The former reform improved the efficiency of resource allocation and the latter ensured the government's ability to continue subsidizing the nonviable firms. Therefore, economic stability and dynamic growth were achieved simultaneously.

Finally, with the shrinking of the SOEs' share in the economy along with the dynamic growth path and the reduction in needs of subsidizing the SOEs, the government gradually eliminated price distortions and administrative allocation, and privatized the small and medium-sized SOEs – most of which were in the labor-intensive sectors and were consistent with China's comparative advantages (Naughton 1995; Nolan 1995; Qian 2003; Lin 2012b). Although there was no mass privatization and the property rights of the collective township and village enterprises were ambiguous, market competition increased and economic performance was improved (Li 1996; Lin, Cai and Li 1998).

The transitional strategy in Vietnam was similar to that employed in China. Through this cautious and gradual approach, China and Vietnam have been able to replace their traditional Soviet-type systems with a market system while maintaining remarkable records of stability and growth.

Incidentally, Mauritius has since the 1970s also adopted a dual-track approach to open up its CAD strategy-type import-substitution economy. It set up export-processing zones to encourage exports and maintain import restrictions to protect nonviable enterprises in domestic import-competing sectors. This reform strategy saw Mauritian GDP grow at 5.9% per annum between 1973 and 1999 – an exceptional success story in Africa (Rodrik 1999; Subramanian and Roy 2003).

However, the completion of transition from plan to market through a dual track approach depends on the elimination of viability problem of firms in the traditional sectors (Lin 2012b). In spite of the extraordinary growth, the Chinese economy has encountered a series of problems, including the rising income disparities, overconcentration of income in the corporate sector, the external imbalances, the widespread corruption, and others. Many of those problems are consequences of the dual-track reform, which retains certain distortions as a way to provide supports to nonviable firms in the priority industries. Major remaining distortions include the concentration of financial services in the four large state-owned banks, the almost zero royalty on natural resources, and the monopoly of major service industries, including telecommunication, power, and banking.

Those distortions contribute to the stability in China's transition process. They also contribute to the rising income disparity and other imbalances in the economy. This is

because only big companies and rich people have access to credit services provided by the big banks, and the interest rates are artificially repressed. As a result, big companies and rich people are receiving subsidies from the depositors who have no access to banks' credit services and are relatively poor. The concentration of profits and wealth in large companies and widening of income disparities are unavoidable. The low royalty levies of natural resources and the monopoly in service sector have similar effects. Rich people and large corporations have a low consumption propensity, therefore a concentration of income to them leads to over-savings and investments, leading to trade large surpluses. Those distortions create rents, rent-seeking, and widespread corruptions.

Therefore, it is imperative for China to address the structural imbalances, by removing the remaining distortions in the finance, natural resources, and service sectors so as to complete the transition to a well-functioning market economy. The precondition for such reforms is to eliminate the SOEs' viability problem.²²

The viability problem of SOEs can be solved according to four different strategies, depending on the nature of the SOEs' outputs (Lin, Cai, and Li 1998, 2001). The first group includes mainly the defense-related SOEs whose production, intensive in both capital and technology, runs against China's comparative advantages, but their outputs are essential for national security. For this group of SOEs, direct fiscal appropriation is necessary for their survival and the government should directly monitor their production and operations. It is reasonable to expect that there are only a few SOEs in this category. The second group of SOEs also requires intensive capital and technological inputs for their production, but their outputs are not sensitive to national security and they have large domestic markets. Examples of this category are the telecommunications and automobile industries. For this category of SOEs, the government can adopt a "market for capital" approach to get access to capital from international markets and remove the adverse impact of the domestic endowment structure on these firms' viability. There are two ways to achieve this goal: one is to encourage SOEs to go public on international equity markets; the second is to set up joint ventures with foreign companies and get direct access to foreign technologies and capital. China Mobile, China Telecom, and China Petroleum have followed the first approach and many automobile makers in China have followed the joint venture approach. The third category of SOEs has limited domestic markets for their products and thus this group of SOEs cannot adopt the "market for capital" approach. The way for them to solve the viability issue is to make use of their engineering and managerial capacities and to shift their production to labor-intensive products, which have large domestic markets and at the same time are consistent with China's comparative advantages. The most famous example of a firm following this approach is the color TV maker, Changhong. This firm used to produce old-style military radar. After switching to the production of color TVs, the firm has dominated the Chinese market and is very competitive in international market. Most SOEs have advantages in engineering and managerial personnel. If they are given the opportunity to shift their production lines to labor-intensive products, many of them can become viable. The fourth group consists of nonviable firms that lack engineering capacity and are thus unable to shift their production to new markets. These SOEs should be allowed to go bankrupt.

After the viability problem of the existing firms is solved, whether or not a firm can earn acceptable profits in an open, competitive market becomes the responsibility of the firm's managers. The performance of a firm will depend on the corporate governance, incentive mechanisms, and other factors, as identified in neoclassical economics.

The government will no longer be responsible for a firm's performance. Only then can the reform of institutions that are inherited from the traditional central planning system with the functions of subsidizing and protecting SOEs be carried out thoroughly and the transition from a planned economy to a market economy completed.

5. Concluding remarks

In this paper, I review the Washington Consensus as a transition approach in former socialist economies and other developing countries from the new structural economics perspective. Economic development, which reflects the ever-increasing average labor productivity and per capita income, is a process of continuous structural changes in technologies, industries, and hard and soft infrastructure. The difference in economic structure for countries at different levels of economic development is a result of the differences in their endowment structure. Firms in an industry will be viable in an open, competitive market only if the industry is consistent with the comparative advantage determined by the economy's endowment structure. Many firms in transition economies and developing countries were not viable because, due to their governments' ambitious development strategies, these firms were in industries against their economies' comparative advantages. Their survival required the governments' subsidies and protections through price distortions, limitations on market competition, and administrative allocation of all kinds of resources. The results of these interventions were inadequate competition, lack of effective corporate governance, rent-seeking, disparities in income distribution, inefficient resource allocation, and, quite possibly, economic crisis. The Washington Consensus, which did not pay sufficient attention to the endogeneity of those distortions, advised the governments to focus the reforms on strengthening property rights, improving corporate governance, removing government intervention in resource allocations, and so on, to improve the efficiency of the market. When a majority of the firms in an economy were nonviable, the implementation of these transition policies led to an awkward situation of shock without therapy, as in the FSUEE and the lost decades in other developing countries (Easterly 2001; Lin and Liu 2004).

Since many firms in plan economies, transition economies, and developing economies are not viable, it is essential to relax the implicit viability assumption in the existing neoclassical economics when applying the neoclassical approach to study the problems in those economies. The relaxation of viability assumption will enrich the neoclassical economics and help to redefine the role of government in economic transition and development. The government needs to be pragmatic in designing its transition strategy when a large number of firms in the economy are nonviable in an open, competitive market. The government should also play an enabling role in a market economy to facilitate the industrial upgrading accordingly to the change in the country's comparative advantage by helping individual firms overcome inherent externality and coordination issues in the development process (Lin 2009, 2011).

After more than two decades of transition from plan to market in FSUEE and China, some economists may call an end to transition economics as a subfield in modern economics (Sonin 2013). However, many nonviable firms and structural problems still exist in the transition economies (EBRD 2013) and, more importantly, structural transformation and transition are permanent features of modern economic development; there is a need for a new transition economics (Pistor 2013). The new structural economics provides an analytical foundation for the new transition economics.

Notes

1. Certainly, a few economists had dissenting views: Stiglitz was a notable example. In his book *Wither Socialism?*, Stiglitz (1994) questioned the desirability of privatization and other basic tenets of the Washington Consensus. Based on the theories of information asymmetry, Stiglitz argues that the government should play an active role to overcome market failures. In a series of articles, Dewatripont and Roland (1992a, 1992b, 1995) also favor gradual reforms over due to the consideration of uncertainty and cost of compensation for losers in the transition process.
2. The package of policies in Williamson's original definition includes fiscal discipline, redirection of public spending from indiscriminate subsidies towards broad-based provision of pro-growth, poverty-alleviating services, broadening the tax base, interest rate liberalization, competitive exchange rates, trade liberalization, uniform tariffs, liberalization of inward foreign direct investment, privatization of state enterprises, deregulation of market entry, prudent oversight of financial institutions, and legal protection of property rights. Subsequent to Williamson's coining of this phrase, the term Washington Consensus has been used to refer to a strongly market-based approach, labeled as market fundamentalism or neoliberalism, in the public discourse, although Williamson himself opposed to this broader definition. In the paper, I refer Washington Consensus to the second, general definition. Responding to the transition experience, John Williamson proposed a much more nuanced definition which incorporates many of the criticisms in this paper (Williamson 2005).
3. There were some economists arguing for an evolutionary, gradual approach to privatization in the transition. For example, Kornai (1990) argues that private property rights cannot be made to work by fiat in the transitional economies where entire generations are forced to forget the civic principles and values associated with private ownership and private rights, and become a mere imitation of the most refined legal and business forms of the leading capitalist countries. Kornai also believes, however, that private ownership is the foundation for a well-functioning market system and privatization is the only way to eliminate SOEs' soft budget constraints.
4. The initial conditions that have been regarded as beneficial to China's transition include high proportions of cheap rural labor, low social security subsidies, a large population of overseas Chinese, and a relatively decentralized economy that helped to achieve some short-term progress.
5. There were also economists who held China's reform in high regard. They include Jefferson and Rawski (1995), McKinnon (1994), MacMillan and Naughton (1992), Naughton (1995), Singh (1991), Harrold (1992), Perkins (1988), Murrell (1991, 1992), Qian and Xu (1993) and Lau, Qian, and Roland (2000).
6. Dell'Anno and Villa (2013) find that the impact of contemporaneous speed of transition reforms on economic growth is negative, but becomes positive in the longer horizon among the FSUEE countries. However, the growth in China and Vietnam outperformed the best performing transition countries in FSUEE.
7. Poland's economic record is the best among the countries of the FSUEE. However, Poland did not completely implement shock therapy. Although prices in Poland were liberalized, most of its large SOEs were not privatized (World Bank 1996; Dabrowski 2001).
8. Kornai (2006) argues that the political and economic transformation in institutions in Eastern European region was a success, however, he also acknowledged that a considerable portion of the population experienced deep economic troubles in the transition process.
9. According to the convention in modern economics, the studies following this approach should be referred as structural economics. The word "new" is added to distinguish these studies from those of structuralism, which was the first wave of developing thinking popular in post World War II, especially in Latin America.
10. The *competitive advantage* of a nation refers to a situation where domestic industries in a nation fulfill the following four conditions: (i) They intensively use the nation's abundant and relatively inexpensive factors of production; (ii) Their products have large domestic markets; (iii) Each industry forms a cluster; and (iv), domestic market for each industry is competitive (Porter 1990). A country's *comparative advantage* is the situation in which it produces a good or service at a lower opportunity cost than that of its competitors. The first condition for competitive advantage is the economy's comparative advantage determined by the nations' endowments. The third and the fourth conditions will hold only if the industries

are consistent with the nation's comparative advantage. Therefore, the four conditions can be reduced to two independent conditions: the comparative advantage and domestic market size. Among these two independent conditions, the comparative advantage is the most important because if an industry is the country's comparative advantage, the industry's product is competitive globally and will have a global market. That is why many of the richest countries in the world are very small (Lin and Ren 2007).

11. The comparative advantage was originally used to analyze the inter-industry trade across countries. Much trade today is of intra-industries. However, if we use production activities as units of observation, comparative advantage is also applicable to the analysis of intra-industry trade.
12. There could be many factors that affect the viability of a firm. In this paper, as well as in my other works, I use the term "non-viability" to describe the inability of normally managed firms to earn socially acceptable profits because of the violation of comparative advantage in their choices of industries and technologies.
13. The models based on increasing returns, such as Krugman (1981, 1987, 1991) and Matsuyama (1991), and coordination of investments, such as Murphy, Shleifer, and Vishny (1989), assume that the endowment structure of each country is identical, and, therefore, that firms will be viable in an undistorted, open, competitive market once the government helps the firms overcome market failure and escape the poor-equilibrium trap. Such models could be appropriate for considering the government's role in assisting firms to compete with those in other countries in a similar stage of development. Such models are, however, inappropriate as a policy framework for developing countries that are attempting to catch up with developed countries because the endowment structures in developing and developed countries are different. With government's help, a developing country might be able to set up firms in advanced capital-intensive industries that have economies of scale; however, because of the scarcity of human and physical capital, the cost of production in the developing country will be higher than that in a developed country. The firms will, therefore, still be nonviable in an undistorted, open, competitive market. As such, the government needs to support and protect the firms continuously after they have been set up.
14. The financial repression discussed by McKinnon (1973) and Shaw (1973) is a result of this strategy.
15. The excessive regulation and administrative control will cause many private activities to escape into informal sectors (de Soto 1987).
16. The soft budget constraint is a term coined by Kornai (1986), which became a popular research subject after the article by Dewatripont and Maskin (1995). According to Kornai, the soft budget constraint is a result of the paternalism of a socialist state; and, according to Dewatripont and Maskin, it is an endogenous phenomenon, arising from a time inconsistency problem. In Lin and Tan (1999) and Lin and Li (2008), I argue that the soft budget constraint arises from the policy burdens imposed on enterprises.
17. In the models of Olson (1982), Acemoglu, Johnson, and Robinson (2001, 2002, 2005), Grossman and Helpman (1996, 2001) and Engerman and Sokoloff (1997), government intervention, institutional distortions and rent seeking arise from the capture of government by powerful vested-interest élites. Logically, their models can explain some observed interventions and distortions, such as import quotas, tax subsidies, entry regulations, and so on. Their theories cannot, however, explain the existence of other important interventions and distortions – for example, the pervasiveness of public-owned enterprises in developing countries, which are against the interests of the powerful élites. Appendix 1 of Lin (2009) provides a formal model for the observed set of seemingly unrelated or even self-conflicting distortions and interventions in developing countries based on the need to support nonviable firms arising from the conflicts between the CAD strategy pursued by the government and the given endowment structure in the economy. However, once the government introduces a distortion, a group of vested interests will be created even if the distortion is created for noble purpose. The vested-interest argument could be appropriate for explaining the difficulty of removing distortions.
18. The difference in the shares of nonviable firms in the economy might explain why the shock therapy recommended by Sachs succeeded in Bolivia but not in the economies of Eastern Europe and the former Soviet Union. Bolivia is a poor, small economy; therefore, the resources that the government could mobilize to subsidize the nonviable firms were

small and the share of nonviable firms in the economy was also relatively small. Stiglitz (1998) questioned the universal applicability of the Washington Consensus. He pointed out that it advocated use of a small set of instruments – including macroeconomic stability, liberalized trade and privatization – to achieve a relatively narrow goal of economic growth. He encouraged governments to use a broader set of instruments – such as financial regulations and competition policy – to achieve a broader set of goals, including sustainable development, equity of income distribution, and so on. Stiglitz's arguments are based on information asymmetry and the needs for government to overcome market failures. However, he did not discuss how to deal with the issue of nonviable firms in developing and transitional economies and the implications of nonviability for choices of transition path and policies.

19. When reform started at the end of 1978, the government originally proposed to raise the agricultural procurement prices, to liberalize rural market fairs, and to reduce the size of production team of 20–30 households to voluntarily formed production group of 3–5 households, but explicitly prohibited the replacement of production team system with an individual household-based farming system. However, a production team in a poor village in Fengyang County, Anhui Province secretly leased the collective owned land to individual households in the team in the fall of 1978 and harvested a bump increase in outputs in 1979. Seeing the effects of individual household-based farming system, the government changed its policy and endorsed the individual household-based farming system as a new direction of farming system reform (Lin 1992). Initially, the collectively-owned land was leased to farm households for one to three years, extended to 15 years in 1985, and further extended to 30 years in 1994. The farm household was obliged to deliver certain amounts of agricultural produce at the government-set prices to fulfill its quota obligation until the late 1990s.
20. The SOE reform proceeded from the profit-retention system in 1979, the contract-responsibility system in 1986, and the modern corporation system from the 1990s to now. Each system was experimented in a small group of enterprises first before that system was extended nationwide (Lin, Cai, and Li 2001; Lin 2012b).
21. The TVE was another institutional innovation by the peasants in China during the transition process. After the HRS reform, farmers obtained a substantial amount of residuals and saw profitable investment opportunities in consumer-products sector. However, due to the ideological reason at that time, the form of private enterprise was prohibited and the farmers used the collective TVE as an alternative to tap into the profitable opportunity. The government initially put many restrictions on the operation of TVEs for fear of TVEs' competition with SOEs for credits, resources, and markets. Only after the government was convinced by the evidences that the TVE was good for increasing farmers' income and for solving the shortages in the urban markets, did the government give green light to the development of TVEs in rural China (Lin, Cai, and Li 2003).
22. Besides the viability problem, the SOEs in China have an additional problem of social burdens. Before the economic transition, the investment in heavy industry provided limited employment opportunities. The government was responsible for urban employment and usually assigned several workers to a job, resulting in labor redundancy in SOEs. The workers also received low wages, which were enough for covering current consumption only. Before the transition, SOEs remitted all their revenues to the government, and the government used fiscal appropriation to cover SOEs' wages, pensions of retired workers, and other expenditures. Therefore, the labor redundancy and the pension expenditure were not burdens on SOEs. After the reforms, SOEs started to be responsible for their workers' wages and retirement pensions. The newly established TVEs, joint ventures, and other nonstate firms are in sectors that are consistent with China's comparative advantage and they do not have the problem of labor redundancy and unfunded pensions for retired workers. I call the issue arising from the viability problem the SOEs' "strategic burden" and the additional cost arising from labor redundancy and pension expenditures the SOEs' "social burden." Together they constitute the SOEs' "policy burdens." As long as these policy burdens exist, the government is responsible for the firms' losses and the soft budget constraint cannot be eliminated (Lin and Tan 1999). There is a consensus in China about the necessity and the way to eliminate the social burdens. Therefore, the remaining issue is how to solve the strategic burden.

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