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Edited by
Shenggen Fan, Ravi Kanbur,
Shang-Jin Wei, and Xiaobo Zhang

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2 Transition to a market economy

Explaining the successes and failures

Joseph E. Stiglitz

China has grown remarkably since it began its transition to a market economy more than three decades ago—far better than Russia.[1] The reasons for this hold important lessons for economics.

There are two categories of explanations for the differences in performance: (a) the two countries faced different circumstances; (b) they undertook different policies. It is impossible to fully untangle the explanations: differences in circumstances would naturally lead to differences in policies. Independent of circumstance, however, various economists did support highly different policies—in pacing, sequencing, and priorities. Some called for shock therapy, focusing on macroeconomic adjustments; others for gradualism, focusing more on microeconomic issues. Different economists held contradicting opinions on privatization—a high priority for Washington Consensus supporters—and on institutions, competition, the role of government, and the pace of liberalization for capital and financial markets and trade.

At least through the first decades of transition, the contrast in the policy bundles pursued by the two countries could not have been greater. Russia followed, though imperfectly, the Washington Consensus shock therapy policies; China followed an alternative course. Inevitably then, the advocates of Washington Consensus[2] policies attribute Russia's (comparative and absolute) failures either to deficiencies in following the prescriptions, or to its different circumstances.

The real flaw, I argue, is with the Washington Consensus and the policies based on it. If anything, the circumstances favoured Russia. Further, even if Russia imperfectly

[1] This chapter is based on previous work (listed in the references) by the author and several co-authors (Karla Hoff, Yingyi Qian, David Ellerman, Athar Hussain, Sergio Godoy, and Nicholas Stern) to whom he is greatly indebted.

[2] There is no way of simply and accurately summarizing the policies advocated by the 'shock therapists' and the international financial institutions. Still, it is useful to group the two strategies according to some basic themes. See Stiglitz (2008).

followed the Washington Consensus policies, China’s successful policies deviated from them even more. In fact, there is a causal link between Russia’s policies and its poor performance, an interpretation consistent with cross-country and time-series empirical work.

A purported defence of the *economic* failure is that there was a political transformation going on as well, which the economic transformation was responsible for ‘locking in’. But the strategy failed to create a vibrant democratic Russia, and the economic strategy may in fact have contributed to this political failure.

2.1 The contrasting performance

Russia’s performance in the initial years of transition was particularly disappointing: between 1990 and 1999, real GDP per capita fell by 38 per cent. There were concomitant indicators of failure, such as a decline of three years in life expectancy and large outmigration of some of the country’s most talented individuals. The country deindustrialized, becoming increasingly simply an exporter of raw materials (especially oil and gas).

Of course, Russia had inherited a distorted economic system. Capital and labour had been misallocated; innovation had been suppressed. But in a sense, that only meant it had more room for improvement. Replacing an inefficient economic system (central planning with decentralization; quotas with market-based incentives) *should* have ensured that the country’s resources were better used. Output should have gone up.

By contrast, in the same period, China’s per capita income more than doubled, and life expectancy increased by two years. Technical capacities grew. By 2010, it was becoming a technological leader in some fields. As it restructured its economy away from primary production, China became the largest producer of industrial goods.

2.2 The flawed economic model

Russia’s failed policies were overly influenced by the neoclassical model, which ignored market frictions (imperfect information, imperfect competition, imperfect markets). In reality, social and private returns were often not aligned. While the advocates of rapid transition prided themselves in at last providing incentives to market participants, what they did not realize was that those incentives were, in many cases, perverse; they were directed more at asset-stripping than at wealth creation.

The irony was that while these policies’ proponents often talked about the importance of ‘governance’, they failed to note pervasive problems of *corporate governance* that can arise when there are inadequate corporate governance statutes.[3] By contrast, the critics of shock therapy stressed the importance of the 'institutional infrastructure', including corporate governance.

Still another flaw in the Washington Consensus was the belief that as government activities (such as providing credit, inputs, etc.) were stripped away, *competitive and efficient* markets would spontaneously arise to fill the gap. Typically they did not. The absence of capital markets (banks) that were experienced in project selection and monitoring and contract enforcement, combined with weak entrepreneurship, meant that when jobs and enterprises were destroyed, new ones were not created.[4]

The advocates of shock therapy also underestimated the importance of social capital in making economies (and societies more generally) function. The Soviet Union had done much to destroy civil society and civic engagement. Even if appropriate legal structures had been put into place, they would have been an imperfect substitute. But transition under shock therapy eviscerated social capital even more and did not create the 'institutional infrastructure' necessary for an effectively functioning market economy—or for democracy.

So too, overly simplistic macro-models that paid insufficient attention to credit and credit institutions led to monetary policies that for a time moved much of Russia back to an inefficient barter system (all in the name of taming inflation).

As a result, Washington Consensus policies (including privatization and liberalization) did not bring the promised benefits. This should not have been a surprise, considering there was little theory and no historical basis for shock therapists' faith in rapid privatization. By contrast, there was ample historical evidence of the problems facing societies in the absence of good legal and financial institutions.

Just as the advocates of the shock therapy model were excessively optimistic about the results they expected, they were excessively pessimistic about the ad hoc nature of the Chinese reforms. But the 'partial' reforms were effective. (a) China's move to the individual responsibility system provided effective incentives in the agriculture sector, even though it did not entail *full* privatization. It provided most of the benefits that would have been achieved with full privatization, without the adverse political and social consequences. (b) China put more emphasis on competition than privatization, especially in the early stages.[5] Both were necessary to achieve the full benefits of a market, and priorities had to be contingent on local circumstances. Township and village enterprises involved continued public ownership (though at the local level),

[3] Berle and Means (1932) stressed the importance of the separation of ownership and control; the economics of information put the theory of corporate governance on rigorous theoretical foundations, see for example Stiglitz (1985).

[4] Ellerman and I (2000) also emphasized the consequences of the absence of small enterprises in the Soviet regime.

[5] Something Arrow and I had suggested in a 1980 conference with Chinese officials. See my 1980 paper.

but provided the basis for vigorous competition. (c) One of the original challenges was how to move from the distorted price system under the old regime to a more market-based price system. The Chinese cleverly used a two-part price system—though conventional wisdom at the time argued against these kinds of pricing mechanisms. (d) China was slow to move to trade liberalization—and even now has not fully liberalized its capital account. Strong government intervention enabled the country to avoid the instability (and often high unemployment) that marked those who liberalized too rapidly. It provided time for development of a domestic entrepreneurial class. (e) Industrialization was also aided by strong industrial policies, including the management of the exchange rate (to keep it competitive)—policies that were eschewed by the Washington Consensus.

2.3 The flawed political model

There was a naïve belief that a newly established class of wealthy individuals would have incentives to create the legal and institutional infrastructure that would enable a market economy to function well. There were at least four key flaws. (a) Those with economic power wish to perpetuate it, devising rules that benefit themselves, but would not necessarily make the economic system work better. Wealthy individuals use their wealth, including through political influence, to enhance their rents: monopolists oppose strong competition laws; financiers, laws that circumscribe their abuses of information asymmetries and market power. (b) With capital market liberalization, the rich in Russia could take their money out of the country and invest it in a place where there were good protections, meanwhile taking advantage of their superior ability at asset stripping. (c) As a result, there was an economic and political equilibrium in which Russia remained 'lawless' (Hoff and Stiglitz 2004a, 2004b). (d) There are further difficulties in leaving a 'lawless' state: those that follow may try to recapture proceeds that are viewed as not gainfully gotten. Illegitimate privatization thus made the process of transition to a rule of law more difficult (Hoff and Stiglitz, 2007).

2.4 Alternative explanations

Supporters of Washington Consensus policies suggest that China's task in transition was easier: it was a less developed, more agrarian economy. But on average, less developed countries (with the exception of the East Asian countries that did not follow the Washington Consensus prescriptions) have not done well. Development is difficult. Transition is difficult. It is illogical to suggest that combining the two would make both tasks easier. And there is little evidence that the ease of transition is related to the size of an economy's agrarian sector.

Many of the studies of transition occurred in the early years. It was not clear then whether the tortoise or the hare would win: even if fast reformers among the FSU and Eastern Europe appeared to be doing well early on, would they be able to sustain their advantage? One of the few studies to be done later on was that of Godoy and Stiglitz (2007), which concludes that the tortoises did win—speed of privatization was negatively correlated with longer-run performance—and that institutions mattered. As time went on, the significance of initial conditions (emphasized in the earlier literature) disappeared.[6]

2.5 Concluding remarks

The end of Communism and the transition from Communism to the market economy was one of history's most important economic episodes. Standard theory had little to say about how to manage that transition, but that did not stop many economists from providing advice. Much of that was wrong; in some cases, it was counterproductive. The contrast between Russia and China is testimony to the benefits of pragmatism and against the reliance on simplistic neoclassical models. The limitations of those models were well known before the transition: if those models had been right, market socialism would have been far more successful (Stiglitz, 1994). Chinese leaders understood that transition required institutional innovations and, untethered by the dictates of neoclassical economics, were able to devise pragmatic solutions that provided the basis of that country's three decades of unprecedented growth.

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[6] As they note, empirical work in this area is plagued by a host of econometric problems. See for example the discussion in Hoff and Stiglitz (2004a, 2004b, 2007).

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