Johannes F. Linn 17 March 2020 jlinn@brookings.edu

<u>Boston University China-West Dialogue (CWD) Workshop</u>

March 20, 2020*

Contribution to Session on "Mixed Economy Pluralism"

Taking the title of this session as the point of departure, let me make three observations and draw some conclusions for the way forward:

Observation 1: I strongly support the notion that in the economic domain, China-West relations would be well served if both sides accepted and supported "mixed market pluralism" as a point of departure for the discussion for China-West economic relations.

In the debate about economic systems there is a tendency to characterize Chinese and Western economic regimes respectively as "state-led socialist" on the one side and "market fundamentalist" on the other. The former is seen as placing heavily reliance on state-owned enterprises, on public investments not only in infrastructure but also industry and technology development, and on managed exchange rates. The latter refers broadly to the economic prescriptions of the Chicago School of Economics in the 1970/80s, to the policies of Ronald Reagan and Margaret Thatcher in the 1980/90s and to what's often (and misleadingly) referred to as "the Washington Consensus".

It is my understanding that one of the central points of the organizers of this conference is that neither of these characterizations of Chinese and Western economic approaches is helpful for fostering a constructive East-West dialogue, but that instead an acceptance of "mixed market pluralism" would be more appropriate as a starting point for building cooperative relations between China and the West. I wholeheartedly agree with this position.

By way of background, let me briefly reflect on my 30 years (1973-2003) working as an economist at the World Bank in Washington, DC, a good place to observe and participate in the debates about state- versus market-led analysis and policy prescriptions.

The transition from the days of World Bank President Robert McNamara (1968-81) and Chief Economist Hollis Chenery to those of President Tom Clausen (1981-86) and Chief Economist Anne Krueger was striking, as the Bank at the top of the organization moved from the orthodoxy of big government and big public sector projects to an approach that aimed to minimize government intervention in developing economies. In reality, of course, the World Bank management and staff – and the development community in Washington and beyond – never swallowed the new ideology lock, stock and barrel. Admittedly, the World Bank in 1986 and 1987 published two World Development Reports on industrial and agricultural policy respectively that were fully consonant with market fundamentalism. But at the same time, Bhattacharya and Linn (1987) published a World Bank paper on trade and industrial policies in the developing countries of East Asia, which endorsed many aspects of the interventionist policies of South Korea and its neighbors in support of their industrial, technology and export development. Moreover, World Development Report 1988 on fiscal policy argued for a much

* I am indebted to Colin Bradford and Homi Kharas for comments on an earlier draft of this note.

more differentiated approach to public sector engagement in development than its two predecessors. To me this came as no surprise, since I served as team leader of WDR 1988 with the support of a new Chief Economist, Stanley Fischer, who like his successors in that position (Larry Summers and Michael Bruno), had a more balanced view of the complementary roles of government and market than his predecessor.

Michael Bruno was succeeded by Joseph Stiglitz, who tended to be more interventionist than his predecessors and a fervent critic of the "shock therapy" pursued by reformers and their foreign advisers in the transition from socialism to markets in Eastern Europe and the Former Soviet Union. Indeed, Stiglitz was a strong supporter of what he saw as the more gradual reforms in China. (Stiglitz, 1999) A few years later (2008-2012), Justin Lin – one of the principal Chinese economic thinkers of his generation – served as the World Bank's Chief Economist and, not surprisingly and not unlike Stiglitz, argued for a more proactive role of government in development than many of his predecessors, let alone the supporters of "market fundamentalism". (Lin, 2012) And, of course, the World Bank consistently supported Chinese economic reforms with economic analysis and advice and with substantial financing ever since it opened up in the 1980s. But not only that: under the leadership of President Wolfensohn (1995-2005), the Bank extracted lessons from the Chinese experience on how to support the effective scaling up of successful development interventions. (Moreno-Dodson, 2005)

I review this bit of arcane World Bank history only to support my following conclusions:

- There is a wide range of views to be found in Western development analysis and practice covering much of the spectrum of views from market-led to state-led economic management.
- The approach chosen by the Chinese authorities for their reform was in fact not all that different from that of other East Asian economies and much of the stunning success of Chinese economic development over last 40 years is due to the fact that China very effectively adopted and adapted what might be called "Western" economic thinking and financial support along with their own policy and institutional priorities.
- Both Western and Chinese economic thinkers and practitioners have generally striven – and often cooperated – in quite similar ways to determine what is the appropriate balance between government and market at different stages of development and in different contexts of global economic, social and environmental conditions.

Of course, there was never universal agreement along the way on what are the most appropriate economic policy paths, nor is there today, as reflected among other things in the debates on economic and social policy across and within political parties in the US. And there are surely differences in economic and institutional policies which Western analysts and policy makers think China should pursue and those that China is actually pursuing, which is the way it should be. The sooner we accept that "mixed market pluralism" is the way forward, i.e., accepting that each country determines what is the best balance between market and state, the more we will likely find common ground in the relationship between China and the West.

Observation 2: The central issue now is who sets the "rules of the game" for international economic relations and how are they being followed and enforced by the various key players.

If the main issue in China-West economic relations is not the tension between a market-led approach in the West versus a state-led approach in China, what is it? I would argue that it is about the rules of the game for international economic relations, who sets them and how are they being followed and enforced by various players. Whether and how the rules are made in a joint and inclusive fashion and how they are enforced has become central for China-West relations and the world as a whole, as efforts are made to reshape the global order in response to its new multipolar structure.

From a Western perspective (principally US and Europe, perhaps also Japan and Latin America), the sense is that China as a developing country has not only been favored by the rules of international trade, finance and climate change, but has bent the rules to its advantage and/or has not followed them where they weren't to its advantage. While this might have been appropriate or could be overlooked in the early years of China's development, now that China has become one of the top economies in size, technological advancement and emissions, a common Western view is that China must follow the rules and not exploit unfair advantages by circumventing them.

From a Chinese perspective China is still far behind Western countries in terms of development as measured for example by GNI per capita and thus deserves rules that allow it to catch up rather than be held back. At the same time China sees itself now as unquestionably a global economic power based not only on its sheer size, but also on its unique history, culture and economic model, as well as on its exceptional trajectory of modernization and growth in recent decades. For these reasons China feels that it deserves a seat at the table as a "rule maker", rather than being just "rule taker" as in the past.

Frictions arising from the difference of perspective between China and the West on the setting of economic rules are further aggravated by three additional factors: (i) the perception in China that the US and the West are abusing their economic power and the global rules by applying economic and financial sanctions to achieve geopolitical goals (such as punishing North Korea, Russia and Iran for various geopolitical and security transgressions) and hence leading to efforts by China to lessen its exposure to such potential economic and financial pressures; (ii) the perception in the West, and in the US especially, that China's projection of global economic influence through its aggressive pursuit of the Belt and Road Initiative (BRI) is an effort to draw much of world into a Chinese geopolitical orbit and into economic dependency; and (iii) President Trump's unilateral contravention of global economic rules established originally under US leadership which further undermine the credibility of these rules.

The last of these three factors, Mr. Trump's populist stance on dealing with international partners and global rules, is however, not just a US phenomenon. Populism and, associated with it, nationalism are on the rise worldwide and undermine sound multilateral, bilateral and national approaches to dealing with economic and political challenges and opportunities in many countries as well as globally. This gives rise to my third observation.

Observation 3: We economists bear some responsibility for the rise of populism since in our quest for efficiency in resource allocation we have given too little attention to the losers from reforms and from structural economic and social shifts.

Students of economics are well trained in the principle of Pareto optimality, which in its most common form (see Box 1) postulates that a change in resource allocation (whether stemming from reforms or autonomous structural shifts in the economy) is efficient if the gains to the winners from reallocation outweigh the losses of the losers and transfers from winners to losers could be designed to offset the losses of the losers. In practice, the operative key word has been "could" for most economists and for their advice to policy makers, myself included through much of my 30-year career at the World Bank. Over the last 40-50 years of "liberal market reform" for greater economic efficiency and in welcoming globalization we swallowed the Pareto optimality principle whole, but forgot that, in order to achieve desirable and sustainable economic, social and political outcomes, we needed to pay close attention to whether or not to compensate losers, how to do so most efficiently and effectively, and then actually getting it done.

Box 1. Pareto optimality: pure – and not so simple

"An economy is said to be in a Pareto efficient (or optimum) state when no economic changes can make one individual better off without making at least one other individual worse off. A Pareto improvement occurs when a change in allocation harms no one and helps at least one person, given an initial allocation of goods for a set of persons."

"In practice, it is almost impossible to take any social action, such as a change in economic policy, without making at least one person worse off, which is why other criteria of economic efficiency have found a wider use in economics. These include "potential Pareto optimality" (or "Kaldor-Hicks efficiency") under which a change in allocation is efficient, if the gains to the winners of the change outweigh the damage to the losers such that there is a set of possible lump-sum transfers of wealth from those who are better off to those who are worse off, and as a result, with those transfers, everyone is at least as well-off as a result of the change."

Source: Quoted from Encyclopedia Britannica (https://www.britannica.com/topic/Pareto-optimality) and Investopedia (https://www.investopedia.com/terms/p/pareto-efficiency.asp), with minor adaptations and underlining added.

We knew, of course, that as part of structural adjustment reforms in developing countries – with the opening up of borders, reduction in protection of traditional industries, elimination of subsidies on energy and utility prices, transformation of education and health systems into cost recovering services, etc. – some people are negatively affected, but we generally failed to pay much attention to this, presumably reasoning that overall, and particularly in the longer term, economic and social benefits would allow all to be better off, especially if we also assisted with the improvement in social safety nets, pensions, etc. We tended to neglect or dismiss the fact that the efforts to improve social safety nets generally were too slow and ineffective to actually protect wide swaths of people from the pain of reforms in the short to medium term. It was therefore not a surprise that most reforms sooner or later ran into political opposition and/or gave rise to populist movements, as the losers felt their losses piled up and no one paid much attention to their plight, while others benefitted greatly from the market reforms.

A similar process in part also explains the rise of populist movements in the advanced countries, as globalization and technological progress led to a hollowing out of traditional industrial economies, migration was perceived to threaten established low and low-middle income communities and their cultural identities, and rising inequality appeared to favor "elites", who increasingly appeared to become disconnected from the broader popular base.

It doesn't have to be that way. In fact, a World Bank report on the first 10 years of post-Soviet transition (World Bank 2002) explicitly considered the economic, social and political impacts on winners and losers from transition reforms, and what could be done about them to ameliorate potential negative impacts. More recently, Bussolo et al. (2019) proposed the development of a new social contract for the countries in Eastern Europe and the Former Soviet Union in the face of rising inequality and perceptions of unfairness. (See Box 2) Finding ways to address the perceived and real concerns of the "losers" from structural reforms and the pressures of globalization must be a priority for Western countries, if they wish to stem the populist push for closing borders to trade, finance and migrants, and for sliding back into an us-versus-them attitude towards other countries, and especially the large emerging market economies.

Box 2. The need for a new social contract in Europe and Central Asia

"Inequality among individuals (or households), usually captured by inequality indexes such as the Gini, has shown a mixed pattern for the Europe and Central Asia region. Compared with the levels at the time of the fall of the Berlin Wall, this *vertical* inequality is, by the late 2010s, at higher levels. Also, it has been shown, that using tax data, the concentration of incomes at the top has increased. However, this report demonstrates that it is persistent unfairness and growing inequality between groups—rather than individuals—that are insidiously corroding social cohesion. Tensions between workers, between generations, and between regions have been increasing. Insecurity, unfairness, and growing tensions among groups have also led to perceptions of increases in overall inequality and influence demands for corrective actions. Fissures in the social contract are becoming more evident. Losers from the distributional tensions—young cohorts, routine task-intensive and low-wage workers, inhabitants of lagging regions—choose to voice their discontent by supporting extreme political movements and parties or choose to exit the social and political dialogue altogether. In terms of rethinking the social contract, rather than prescribing or even identifying a specific set of policies, the report proposes a set of three policy principles that, considered jointly, could help level the playing field and redesign a stable social contract. The principles consist of (1) moving toward *equal protection* of all workers, no matter their type of employment, while promoting labor markets' flexibility; (2) seeking *universality* in the provision of social assistance, social insurance, and basic quality services; and (3) supporting *progressivity* in a broad tax base that complements labor income taxation with the taxation of capital."

Source: Bussolo et al. 2019, p. xiv

Conclusions: Some suggestions for the way forward.

Five responses would be appropriate:

1. China and the West learn to accept that their economic systems, while inevitably all belonging to the "mixed economy" type, will differ in important aspects.
2. If they want to live in reasonable harmony and free from destructive economic conflict, China and the West strengthen and further develop the multilateral rule-making

processes and institutions in ways that include China as a rule maker and encourage stronger compliance by all, including and especially by China and the US.

3. To stem the populist and nationalist tide, Western countries will find ways to renew their social contract to assure those potentially left behind in the wake of structural transformation and cultural changes attendant to globalization (including migration) and of technological change and modernization, that their interests are not neglected and that they can share fairly in the overall benefits and not only in the long run.
4. In projecting greater economic influence around the globe and in seeking to close gaps in relative prosperity and national security, China avoids an aggressive nationalist stance, seeking collaborative rather than confrontational solutions, and work with multilateral institutions to help depoliticize such initiatives as BRI.
5. All concerned parties strengthen multilateral institutions for helping resolve potential economic conflicts, for dealing with global threats (climate, epidemics, etc.), for supporting continued economic convergence among developed and emerging economies, and for helping those countries that are least developed and/or in conflict or fragility.

References

Bussolo, Maurizio, María E. Dávalos, Vito Peragine, and Ramya Sundaram (2019). *Toward a New Social Contract: Taking On Distributional Tensions in Europe and Central Asia.* Europe and Central Asia Studies. Washington, DC: The World Bank. https://openknowledge.worldbank.org/bitstream/handle/10986/30393/9781464813535.pdf?sequence=10&isAllowed=y

Bhattacharya, Amar and Johannes F. Linn (1987). "Trade and Industrial Policies in the Developing Countries of East Asia." *World Bank Discussion Paper* 27. Washington, DC.: The World Bank. http://documents.worldbank.org/curated/en/319691468749800317/pdf/multi-page.pdf

Lin, Justin Yifu (2012). *The Quest for Prosperity: How Developing Economies Can Take Off Justin Yifu Lin*. Princeton, NJ: Princeton University Press.

Moreno-Dodson, Blanca, ed. (2005). *Reducing Poverty on a Global Scale.* Washington, DC: World Bank.

Stiglitz, Joseph E. (1999). "Whither Reform? Ten Years of the Transition." Keynote Address at the World Bank Annual Bank Conference on Development Economics. Washington D.C.: World Bank, April. https://openknowledge.worldbank.org/handle/10986/13839

World Bank (2002). *Transition – The First Ten Years: Analysis and Lessons for Eastern Europe and the Former Soviet Union.* Washington, DC. https://siteresources.worldbank.org/ECAEXT/Resources/complete.pdf