The Washington Consensus

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In 1989, John Williamson outlined a set of desirable economic reforms targeted at developing countries that he deemed broadly supported by policymakers in Washington. Dubbed the “Washington Consensus”, it addressed economic policy instruments perceived by those in Washington to be important to both the growth of developing countries and their ability to secure financial support and investment. The ten topics addressed were as follows:

- **Fiscal Discipline**: Large and sustained fiscal deficits contribute to inflation and capital flight. Therefore, governments should keep them to a minimum.
- **Public Expenditure Priorities**: Subsidies need to be reduced or eliminated. Government spending should be redirected toward education, health, and infrastructure development.
- **Tax Reform**: The tax base “should be broad” and marginal tax rates “should be moderate.”
- **Interest Rates**: Domestic financial markets should determine a country’s interest rates. Positive real interest rates discourage capital flight and increase savings.
- **Exchange Rates**: Developing countries must adopt a “competitive” exchange rate that will bolster exports by making them cheaper abroad.
- **Trade Liberalization**: Tariffs should be minimized and should never be applied toward intermediate goods needed to produce exports.
- **Foreign Direct Investment**: Foreign investment can bring needed capital and skills and, therefore, should be encouraged.
- **Privatization**: Private industry operates more efficiently because managers either have a “direct personal stake in the profits of an enterprise or are accountable to those who do.” State-owned enterprises ought to be privatized.
- **Deregulation**: Excessive government regulation can promote corruption and discriminate against smaller enterprises that have minimal access to the higher reaches of the bureaucracy. Governments have to deregulate the economy.
- **Property Rights**: Property rights must be enforced. Weak laws and poor judicial systems reduce incentives to save and accumulate wealth.
Over the course of two decades, these policy instruments have been put to the test. In light of debates, disputes, and domestic and international economic crises, it is time to revisit, revise, and restate the importance of all ten policy instruments listed above.

The three main ideas presented in the Washington Consensus are macroeconomic discipline, the development and promotion of a market economy, and a general degree of openness to the world. Williamson has gone on to include the need for crisis aversion and macroeconomic stabilization, strong institutions, and a focus on who receives increases in wealth as important components of the consensus. Given Williamson’s own addition of new factors to be considered, the critique of individuals such as Nobel-winning economist Joseph Stiglitz, and lessons learned from over twenty years of observation, the proceeding sections of this paper will address all ten of the original points set forth in 1989.

**Fiscal Discipline**

The first component of the Washington Consensus is fiscal discipline. As stated by Williamson, “there is very broad agreement in Washington that large and sustained fiscal deficits are a primary source of macroeconomic dislocation in the forms of inflation, payments deficits, and capital flight.” While there has been a clear shift in recent history towards Keynesian-style stimulation via large public deficit spending, it still holds true that fiscal discipline is necessary. This is particularly true in those developing countries in which institutions lack transparency, freedom from corruption, and the capacity to efficiently allocate funds where they are needed most.

As it relates to inflation, simple macroeconomic theory shows that an increase in government spending, funded through the increase of the money supply, results in inflation. The
maladies of high inflation are so clearly seen throughout history that they need not be discussed in detail. Just as easily observed is the fact that as spending outpaces revenues, funding must be obtained from other sources. When this happens foreign borrowing increases, resulting in large payment deficits that burden governments and their people for years to come.

The economic crises that have occurred since the introduction of the consensus have shed new light on the issue of fiscal discipline. Citing trends in fiscal policy relating to the recent recession, it is clear that the interpretation of what constitutes fiscal discipline may be relaxed or altogether overlooked when a country is facing an economic crisis. Worries about inflation and an increase in payment deficits may take a backseat to the desire to stimulate domestic consumption and job creation. This serves to highlight the importance of fiscal discipline prior to significant government intervention. The elimination of large deficits during periods of economic stability or growth provides an opportunity to build budget surpluses. A surplus or low public debt during periods of strong economic growth leaves a government room to take drastic measures when needed.5

**Public Expenditure Priorities**

Fiscal discipline requires a prioritization of public expenditures or an increase in revenues generated by the government. Because of the negative effects associated with increasing taxes on individuals and businesses (such as decreased discretionary spending and increased opportunity for the misuse of public funds), prioritizing public expenditures and then making cuts accordingly is a superior approach. Williamson identifies five areas of public expenditure to be considered when attempting to reduce government spending. These include spending on the
military, public administration, subsidies, education and health, and public infrastructure investment.  

Military spending is as much a sovereign decision as any one issue can be. While there will always be debate about how much is enough, how much is too much, and what sorts of military capabilities are necessary, mandating levels of military investment as conditions for international financial institution investment should be largely out of consideration.

Similarly, spending on public administration is necessary. However, this does not mean that transparency should not be increased. Because any IMF or World Bank funding will be adversely affected by inefficiency and corruption, transparent accounting and procurement procedures need to be stressed as a necessary component of the Washington Consensus. This would serve to curb waste and graft while not impinging upon the sovereignty of the government. It would also serve developing countries with a large degree of inefficiency and corruption to take advantage of NGOs and other non-profit organizations that work to promote increased transparency and reduced corruption. By reducing losses in public administration, expenditures will decrease and money will be saved moving forward. It will also maximize investments on other public expenditure priorities.

This leaves subsidies, education and health, and public investment in infrastructure open to analysis. Public expenditures on education and health are needed in developing countries, as they result in increased productivity. Furthermore, the investments help the disadvantaged segments of the population and provide a means by which to gain a higher standard of living. These sorts of investments will also dramatically decrease the need for international funding directed at the development of human capital. For this reason, public expenditure on education
and health should remain a high priority for any developing country. The rapid growth of the 
Asian Tigers\(^1\) from the 1960s to the 1990s provides an example of the value that can be created 
through investments in human capital. However, it should be noted that Sri Lanka, which has a 
literacy rate of 90.7\%, proves that investment in education alone is not the solution to long-term 
economic growth.\(^7\)

Public investment in infrastructure is another area that fosters economic growth in the 
long-term. Infrastructure investments provide needed access to utilities, modes of transport, and link regional economies to allow markets to both develop and be serviced. Yet governments should be weary of over extending themselves in this area. Recent trends in international development assistance indicate government funds are not as necessary as they once were due to an increase in private investment in infrastructure development. Rather than simply funding projects, governments in developing nations would benefit from partnerships and private investment contributing to the construction and maintenance of physical infrastructure.

Subsidies are a prime candidate for providing significant reduction. As industries grow and are able to take advantage of economies of scale, subsidies can become a key example of concentrated benefits and dispersed costs; it is a reallocation of wealth rather than a wealth-producing program. Governments need to significantly reduce subsidies, however eradicating them is both unrealistic and possibly detrimental in the earliest stages of development. Subsidies should be retained only where they are needed to promote the growth of potentially important industries in a developing country’s future. Those that do remain need to be paid out in a transparent, justifiable, and non-discriminatory fashion. Where possible, there needs to be a clear timeline for the removal, or at least a rollback, in the level of subsidies being paid.

\(^1\) Hong Kong, Singapore, South Korea, and Taiwan
Tax Reform

Tax reform must remain a central component of any revision of the Washington Consensus. Yet, it may represent an opportunity for predatory governments to prey upon their citizens, transferring wealth away from some and denying others economic opportunities. Often, income redistribution via taxation can become a zero sum or even negative sum action. Taxation can however provide the government with needed funds for services that can increase the standard of living and spur job creation. In such instances, it becomes a positive sum activity; for example, the way government investment in education may lead to increased productivity and higher standards of living.

The Washington Consensus originally called for a broad tax base with marginal tax rates. While this remains necessary today, tax reform should be addressed in greater detail. For instance, consistent application of the tax code is necessary to guard against the arbitrary seizure of private funds by the government. The most developed nations also show a preference for a progressive tax code, allowing less advantaged segments of their population to hold onto a larger percentage of their income while relying on wealthier citizens for larger contributions to publicly funded programs. While this should not be a necessary condition of any tax reform, such programs should not be frowned upon or deemed an impediment to economic growth as this has largely been the path blazed by the industrialized nations.

Offering tax-based incentives to private firms also represents an opportunity for developing countries to create robust economic sectors and attract investment from foreign firms. Consider Ireland’s economic ascension in the later part of the twentieth century. By using tax revenues to fund education programs, and lowering tax rates to attract investment and encourage
large firms to relocate in Ireland, the country became a European economic power.\textsuperscript{8} Similarly, the American government has used tax credits to employers in order to encourage the creation of new jobs. Both of these examples show different ways that governments can utilize tax policy to their advantage to promote economic growth. While no revised version of the Washington Consensus should mandate any of these policies, educating governments of developing nations on the potentially beneficial use of tax incentives would be a positive step towards growth.

**Interest Rates**

The original consensus set forth two general principles regarding interest rates. The first was that interest rates should be determined by market forces. This was necessary to avoid the rationing of credit by arbitrary criteria. The second principle was that interest rates should be sufficiently positive as to encourage savings while simultaneously discouraging capital flight (capital flows will be addressed in more detail in a subsequent section).\textsuperscript{9} Both of these principles remain important today. What has become increasingly important is the method by which interest rates are adjusted.

Central banks must function in accordance with the ebb and flow of the market. As has been shown, adjusting interest rates for the purpose of encouraging or discouraging investment can lead to the creation and destruction of bubbles, leading to economic booms and busts. Interest rates set too high above the market rate will attract foreign capital that can be withdrawn and create massive instability. It will also stifle domestic borrowing. Conversely, interest rates that are set too low will result in a large domestic demand for capital that cannot be met by domestic banks due to a lack of funds. A very low interest rate also gives a central bank little room to maneuver through a crisis by lowering interest rates to encourage domestic borrowing.
and spending. In summary, the Washington Consensus was right to state that interest rates should be determined by market forces and should remain positive to attract investment yet not so high as to encourage an unsustainable inflow of foreign investment. Central banks must retain the power to halt interest rates when they begin to rise excessively and stop them when they begin to fall in order to maintain their use as a policy mechanism during times of economic crisis.

**Exchange Rates**

A developing country’s exchange rate is one issue that has grown in relevance since the initial formulation of the Washington Consensus. The ability of exchange rates to promote economic growth in export sectors has become more apparent. This is due in large part to the success that China has had in maintaining such a “competitive” real exchange rate and reaping the benefits by exporting an enormous quantity of manufactured goods. A competitive real exchange rate is one that allows for the purchase of domestically produced goods at a comparatively low price with foreign currency by foreign buyers. The balance of payments deficit that may have been created by obtaining loans from international finance institutions and investors or other sources is overcome by inflows of foreign currency to purchase goods and services. If the macroeconomic objectives of the government are the growth of the export sector and the simultaneous reduction of the deficit in the balance of payments, then competitive exchange rates are appropriate. It should be noted that this sort of exchange rate is only compatible with an outward-oriented economic plan. This outward orientation is, and should remain, one of the hallmarks of the Washington Consensus.
Despite the advantages of maintaining a competitive real exchange rate, developing countries need to acknowledge the potential consequences. Setting a competitive exchange rate may be done by fixing the exchange rate to a strong currency or an index of currencies. However, as is the case with China, consistently low real exchange rates may bring harsh criticism over time. China now faces accusations of currency manipulation. Many critics, specifically Americans, claim that China has kept its currency artificially low. They claim that this amounts to a subsidy that is paid to domestic producers. Because China is a member of the WTO, they faced the very real possibility of a case being filed with the Dispute Settlement Board. If a case is to be brought and the ruling is issued against China, those who brought the case may be entitled to an unprecedentedly high level of compensation. This is not to say that any developing nation may find itself in a similar situation, but when deciding where to fix the real exchange rate to produce competitive exports, care should be taken in selecting an appropriate value. Exchange rate policy may need to be readdressed in time.

Trade Policy

Trade policy represents an opportunity for developing countries to reaffirm their commitment towards outward orientation. By allowing imports into their country, developing populations may reap the benefits of economies of scale and the comparative advantage of other producers of goods and services. The Washington Consensus was correct to identify the importance of removing protectionist measures that make intermediate goods used in the production of exports more expensive, directly impacting domestic exporters. The potential for protectionist trade measures to be injurious rather than sustainable has been made quite clear.
Consider the practice of “Dependencia” undertaken by Latin American countries and the Soviet Union’s attempt to exist as a self-sufficient country prior to its collapse. Both practices resulted in the impoverishment of their people. Protectionism may also breed corruption, or fuel it where it already exists. Subsidies may be handed out arbitrarily, specific businesses with government access may be favored, or any number of other corrupt practices may be undertaken. By and large, the trade liberalization has proven to be a mechanism for economic growth and poverty reduction since the writing of the Washington Consensus in 1989.

This is not to say that all protectionist trade measures need to be removed. The protection of infant industries provides a convincing argument for the establishment of protectionist trade measures. The growth of the Asian Tigers and Brazil supports the idea that careful protectionism can lead to the establishment of a robust industrial and service-providing sector. However, these protectionist measures must be applied uniformly across all sectors of the economy and there must be a plan for revising and removing protectionist measures as industries move from infancy to maturity. One potential solution to this problem is to seek membership with the World Trade Organization (WTO) as industries become able to compete in the global marketplace. Joining the WTO serves to keep domestic policymakers from enacting protectionist measures and also gives developing countries a means by which to secure access to markets in developed nations. The Dispute Settlement Body has established its legitimacy and has proven that small, less developed nations can still bring and win cases against the largest developed nations in the world. It is important that developing countries wishing to join the

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ii “Dependencia” was a Latin American import-substitution policy in which countries excluded themselves from the international trading system in an effort to become self-sufficient and decrease their perceived dependence on developed economies.
WTO do so at their own pace and do not prioritize membership commitments over the needs of their people.

**Foreign Direct Investment**

Foreign direct investment (FDI) allows for the procurement of much needed capital, the development of skills, and the transfer of knowledge and technology. This has not changed over time; on the contrary, the importance of foreign direct investment to developing countries has grown. What have evolved are the preferred methods for encouraging FDI.

The Washington Consensus discussed the idea of debt-equity swaps as a means by which to promote foreign direct investment. Because of the problems associated with this, most notably inflation, this is no longer the most favorable way to encourage long-term investment. Rather, developing nations must work to produce an environment that is conducive to conducting business. This means the creation of strong institutions that provide a degree of predictability. This will make the investment climate more favorable to the inflow of foreign capital in the form of FDI. Governments can also make commitments to organizations such as the World Bank’s Multilateral Investment Guarantee Agency and the Overseas Private Investment Corporation. Doing so allows investors to insure their investments and receive compensation in the event that government actions result in the loss of capital. Tax incentives, such as tax credits for the investment of fixed capital or the education and employment of local citizens, represent another tool governments can use.

A final consideration is the growing trend in the prevalence of Public Private Partnerships. Rather than simply offering incentives and creating a stable business environment (which is easier said than done), governments may form partnerships with private parties in which each
group takes advantage of its unique position to bring their own resources into specific projects for the benefit of all groups involved. FDI remains a very important tool for developing countries to use, and the means by which to procure investment has changed over time. Countries that stand to gain from FDI must be aware of new methods to obtain capital and should be encouraged to do so.

**Privatization**

Privatization is an area in need of revision. It was correctly stated that the main rationale for privatization is the belief that private industry is “managed more efficiently” than a state run industry because of the incentive structure facing managers. The profit and loss system, as well as the potential for bankruptcy, provides incentives to manage operations as efficiently as possible. This has not changed; it still remains a basic economic principle and individuals respond to incentives. The threat of losing money or losing one’s job will encourage that individual to increase their efficiency and productivity. Williamson was also correct in identifying the short-run and long-run budgetary benefits of privatizing state-owned enterprises. In the short-run, governments will obtain funds from the sale of the enterprise. In the long-run, the government cuts out expenditures needed to maintain the enterprise, increase production, and encourage innovation in order to remain competitive. For all of these reasons, privatization should still be encouraged in many circumstances.

Despite the obvious advantages of privatization, history has taught us that it is not always the correct remedy. Consider the privatization of many state-owned Russian enterprises near the end of the twentieth century. In one instance, privatization was rushed in anticipation of the election of a communist legislature that would have blocked any attempts at the sale of state-
owned enterprises. Businesses that were not ready to be privatized were rushed into the process and the outcomes were poor.iii In other instances government officials needed funds for their campaigns. They traded shares in state-owned enterprises for loans from business tycoons, and eventually sold many of the largest, most profitable businesses in the country for unreasonably low prices.12 These examples teach two important lessons. The first is that industries must be ready to be privatized in order to function efficiently. Williamson himself acknowledged that it is more important to do things right than to do them quickly.13 The second is that privatization procedures must be transparent and fair. They should be in the interest of the population as a whole, rather than powerful individuals or groups. A final consideration must also be given as to whether or not a business should be privatized at all. Many businesses that provide utilities operate as natural monopolies because of the enormous start-up costs associated with competition in the industry. These costs are then passed on to the consumer. Similarly, the provision of a good such as public transportation may necessarily rely on public support to remain cost-effective. For these reasons, it can be said that privatization is a positive process as long as it is done where needed and in an appropriate manner.

Deregulation

Deregulation is another policy instrument that is in need of revision following the experiences of the last twenty years. It remains true that deregulation within an economy promotes fair competition. India’s elimination of the Permit Raj, a bureaucratic jumble that governed licensing and the establishment of new businesses, provides empirical evidence of the power of deregulation to jumpstart an economy. Other issues noted specifically in the

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iii For example, prior to the imminent election of a communist government in Russia, many businesses were hurriedly privatized to avoid communist interference in the process.
The Washington Consensus are price controls, import barriers, discriminatory credit allocation procedures, tax rates and reduction mechanisms, and limits on labor markets. Many of these issues have been addressed and their importance has been made clear. The increase of competition is not the only reason for decreasing regulation. Decreases in regulation also discourage corruption; there are fewer opportunities for corrupt officials to extort bribes or reallocate funds at their discretion. Deregulation also decreases rent-seeking behavior. Funds that may have been allocated for obtaining preferential treatment can be invested in hiring new employees or innovating within a competitive marketplace.

The Washington Consensus needs to be revised as it relates to the regulation of capital markets. The Asian financial crisis highlighted the potential for short-term capital flows to destabilize economies and have an effect throughout the world. As regional economies continue to become integrated, the potential for destabilization to reverberate throughout the world will increase. The argument in favor of capital market liberalization is based on the idea that it leads to higher output and efficiency. This argument has five components: countries should be concerned with GNP rather than GDP, international competition for funds creates the incentive for countries to create an attractive business environment, stabilization can be achieved through diversification, capital markets allow access to needed sources of funds, and it represents the free flow of goods and services. However, fault can be found with each one of these points, particularly with the argument in favor of stability through diversification. This is because these investments can be withdrawn as quickly as they can be made in a liberalized capital market. The case for intervention is based largely on the negative externalities generated by the destabilizing flows on capital. One reason that China and India were so successful in navigating the Asian financial crisis was their ability to control short-term capital flows. Instead,
they encouraged foreign direct investment and have not suffered as a result. For this reason it may be wise for governments to regulate the inflows or outflows of capital either through capital controls or taxes on short-term investments moving into or out of the country. While there is no perfect way to address this issue, developing countries should acknowledge the potential for destabilization and make a conscious decision as to whether or not they will regulate capital flows.

Property Rights

Property rights may be the most underemphasized component of the original Washington Consensus. They are essential to the efficient functioning of a capitalist system. Hernando De Soto offers the most poignant analysis of why this is the case. He states that well defined private property rights have six effects: fixing the economic potential of assets, integrating dispersed information into one system, making individuals accountable to their commitments, making assets fungible, networking individuals, and protecting transactions. Simply stated, property rights allow for the drafting of binding contracts and the transfer of property from one party to another. Equally important to the existence of property rights is the manner in which they are established. De Soto discusses at great length the informal agreements on property rights that evolve out of the lack of a formal system. What these informal agreements lack in formal support, they make up for in local legitimacy. Any system of property rights that grows in developing countries should be based on the informal agreements already in place. While enacting such laws will require an enormous upfront cost in attempting to gather information that is not easily accessible, it ensures that a system of property rights will be well received by those it will benefit. Consider the case of mining rights in the American West. Initially there were no laws to govern claims. As more individuals moved west, informal systems of property rights and
enforcement evolved. When the American government sought to formalize property rights they based the laws on the informal rules set by the miners. This ensured law and order while also establishing a system that was congruent with the local norms. While the establishment of secure, transferable property rights in developing countries is critically important, so too is the manner in which property rights are defined and enforced.

**Summary and Conclusions**

The policy issues addressed in John Williamson’s 1989 Washington Consensus maintain their importance today. While political and economic events, including the world economic crisis, have drawn attention to the weaknesses of the consensus, the main points remain the same. Yet several issues are in need of revision. The following represents a new Washington Consensus, taking into account the need for changes relating to different areas of policy:

- **Fiscal Discipline**: During times of economic growth, governments should maintain low budget deficits and attempt to run a surplus. This allows for Keynesian stimulation during times of economic crisis.

- **Public Expenditure Priorities**: The government should be transparent and judicious in its payment of subsidies. Spending should go towards education, health, and infrastructure projects. Governments should also seek private investors in these areas.

- **Tax Reform**: The tax base should be broad, tax rates should be marginal, and application of the tax code should be consistent. Governments should recognize that proper use of tax incentives can promote growth.

- **Interest Rates**: Interest rates should be determined by the market and remain positive. They must not fall so low as to prevent the use of monetary policy in times of economic crisis.

- **Exchange Rates**: Countries seeking to increase exports should maintain a competitive currency. As the economy grows, the exchange rate may have to be adjusted to allow for increased imports into the domestic market.

- **Trade Liberalization**: Trade liberalization offers unparalleled opportunities for economic growth and increases in the standard of living. Infant industries
may need protection, but this should be well-defined and short-lived. The WTO offers small countries an opportunity to access large markets and take action against injurious protectionist measures enacted by larger developed countries.

- *Foreign Direct Investment:* Foreign direct investment can bring needed capital, skills, knowledge, and technology. Developing countries should be aware of the many different ways in which they can attract FDI.

- *Privatization:* Privatization of most state-owned enterprises can increase efficiency and decrease government spending. Privatization must be done correctly, and not all enterprises need to be privately owned.

- *Deregulation:* Deregulation can decrease corruption and increase competition. Governments should be aware of the potentially destabilizing effects of capital flows and should take some position on the issue to ensure awareness.

- *Property Rights:* Well defined, transferable property rights are essential to a capitalist system. Property rights should grow out of existing informal arrangements in order to maintain legitimacy.

Many of these suggested changes reflect two basic deficiencies of the original consensus. The first is the lack of attention paid to the importance of institutions. Strong institutions provide a stable environment in which to conduct business and government transactions. They allow for the conversion of uncertainty into quantifiable risk, which allows individuals to plan for the future. The second is the inability to deal with economic crisis, an Achilles heel that is particularly relevant now. This is largely accounted for by the changes in fiscal discipline, interest rates, and deregulation. Moving forward, there is no reason to assume that the Washington Consensus must be dramatically revised or disregarded. It is important to remember that no two countries are alike, and that this is not a “one size fits all” approach to international economic development. The policy issues it addresses will remain important in the future, and the basic outline it provides illustrates a potential path to economic growth and social progress in developing countries.


Ibid.


Bibliography


