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## STATE'S ROLE AND METHODS OF IMPACT ON ITS ECONOMY IN A TRANSITION PERIOD

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### INTRODUCTION

The main problem of how to transform a centrally planned market into a market economy has emerged as one of the most influential and challenging issues in modern times. Nowadays, post-Soviet republics and nations of Central and Eastern Europe are in a transformation process and seek to capture claimed efficiency and advantages of market mechanisms for their economies. This is a very complex issue, because a rapid transition from socialism to a market economy is an unprecedented phenomenon and requires fundamental restructuring of a nation's economic, political, social and legal institutions as well as its physical infrastructure.

The term “**transition economy**” refers to the direction of reforms that are to be implemented in developed as well as underdeveloped countries. The usage of the term “transition economy” depends on the necessity for one concrete term to designate the socio-economic unity, going on in post-soviet countries after the government's political decision to liquidate the centralised governmental monopoly and administration of ownership and establish market relations based on emerged private ownership of institutions. These changes set up a transformation intended to develop market-based institutions, which should mean economic liberalisation, where prices are set by market forces

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rather than by central planning state institutes. In a market economy trade barriers are removed. There is a serious push to privatisation of state-owned enterprises and resources, and the state and collectively run enterprises are restructured businesses. On the other hand, a financial sector is created to facilitate macroeconomic stabilisation and free movement of capital.

There are no historical precedents of the transformation of a centralised planned economy into a market economy like in the former Soviet Union and Eastern European countries. Decentralisation of the economic management and planning system, a faulty administrative system operating for decades, inflexible and low efficient economic mechanisms, disregard of national interests, which was due to the soviet epoch, and the attempt to carry out irrational, mutually exclusive reforms drew the Soviet economy and finances on the verge.

The period of 1985–1990 revealed the tendency to slow down the national economy development: aggravated social sphere problems, worsened cultural and material welfare, and decreased indicators of public production efficiency. Together with economic life, traditional economic links broke down significantly, low production economic crisis intensified, domestic industry and inter-industrial disproportion growth increased, and finally, slow economic and social development occurred. Somewhere around the 1990s it was obvious that within the given system it was impossible to improve the economy. Socialist directive planning prevented economic development. The center was not able to control the processes in the former USSR so it became vitally important to transform the established political system and abandon their planned economy.

The countries under transition are striving to speed up the process of their economic, technical, technological, management development related, material and cultural values by using the experience of leading countries. The development of a new socio-economic system is a hard and prolonged process. It is affected by the political, economic and social, technical and ecological development and particularly by the specifics of the country concerned. Besides, it should reflect the ways out of a crisis, the stages of economic stability and the objectives of the development. Among the tendencies occurring within a transition economy we can list the following: the regulating tendencies of economic processes, which should be accomplished by a government's economic policy; the new technical-technological trends of economic development, which are not able to provide new sources of economic growth, and the formation of a modern economic structure; the confirmation of the necessity of establishing market relations for effective distribution

of resources; striving to open a market economy, which, resulting from the objectives of efficient economic growth, determines the borders of economic openness; and a tendency towards the formation of progressive society.

There is no unified package of reforms that would be suitable for all countries in transition, because their conditions differ. Moreover, there is a disagreement about what types of reforms should be undertaken by each country. Furthermore, it has recently become evident that the most important thing to do is to determine the key elements of reforms. While working on the economic reform programme, a government should first of all concentrate on fostering the growth of social welfare; and guarantee progress to the socially unsecured, especially in such circumstances when prices increase and a severe monetary and fiscal policy leads to unemployment. In transition economies it is essential to create and put into operation new institutes, systems and laws: laws that guarantee private ownership rights, regulate contracts/agreements, corporate organisational and bankruptcy procedures; tax paying systems, which are based on strictly defined rules and regulations; other systems, especially those, which strictly determine the obligations and rights of accounting; information systems (accounting, audit of the system of national accounts).

In order to improve the ability of potential growth, the countries with a planned economy bravely headed towards a market economy, which requires a set of fundamental changes and the development of new types of production relations. They should by all means dispose of the lifeless resources accumulated in the earlier economic practice; at the early stage of the transition significant fall of production is observable but it is important to guarantee economic growth in order not to make the transition period either too harmful or too long; otherwise the willingness to support the economic reforms may decline and even disappear completely, which is the key factor in the process of providing a successful economic transformation.

## MAIN ELEMENTS AND THE PROCESS OF TRANSITION

Property rights are considered the most basic element of a market economy. The implementation of these rights is a key indicator of the transition process. Other “ingredients” of the transition process are as follows:

- **Liberalisation** – the process of allowing prices to be determined by free markets, lowering trade barriers that shut off contact with the price structure of the world's market economies;

- **Macroeconomic stabilisation** – bringing inflation under control and lowering it over time, after the initial burst of high inflation that follows from liberalisation and the release of pent-up demand. This process requires discipline over the government budget and the growth of money and credit and progress towards sustainable balance of payments [Aristovnik, 2006];
- **Restructuring and privatisation** – the creation of a viable financial sector and reforming the enterprises in these economies to render them capable of producing goods that could be sold in free markets and transferring their ownership into private hands;
- **Legal and institutional reforms** – redefining the role of the state in these economies establishing the rule of law, introducing competition policies [IMF 2000].

A transition process in the broad sense of the term implies liberalising economic activity, prices, and market operations, along with re-allocating resources to their most efficient use, developing indirect, market-oriented instruments for macro-economic stabilisation, achieving effective enterprise management and economic efficiency, usually through privatisation; imposing hard budget constraints, which provide incentives to improve efficiency and establishing an institutional and legal framework to secure property rights, the rule of law, and transparent market-entry regulations [Havrylyshyn, Wolf, 2009].

The European Bank for Reconstruction and Development (EBRD) developed a set of indicators to measure the progress in transition. The classification system was originally created in the EBRD's 1994 Transition Report, but has been refined and amended in subsequent reports. The EBRD's overall transition indicators are: large-scale privatisation, small-scale privatisation, governance and enterprise restructuring, price liberalisation, trade and foreign exchange system, competition policy, banking reform and interest rate liberalisation, securities markets and non-bank financial institutions, and infrastructure reforms [EBRD, 1994: 11].

There are several strategies that nations adopted in transition processes. The most influential one was adopted by Poland and launched in January 1990. This strategy was strongly influenced by the IMF and World Bank. These two powerful international financial organisations analysed the successful and unsuccessful stabilisation programmes, that had been adopted in Latin American countries in 1980s. This strategy included a number of measures such as macro-economic stabilisation, liberalisation of wholesale and retail prices, removal of constraints to the development of private enterprises and the privatisation of state-owned enterprises, elimination of subsidies

and the imposition of hard budget constraints, creation of an export oriented economy that was open to foreign trade and investment. The creation of a social safety net targeted at the individual to compensate for the removal of job security and the removal of price controls on staple goods was also part of the strategy [Alan Smith, 1995: 5].

The choice between these strategies was influenced by many post-socialist critical states. Policy makers from these states were persuaded that political credibility took precedence over a sequenced reform plans and to introduce macro-economic stabilisation measures ahead of structural measures that would by their nature take longer to implement. This credibility was enhanced by the adoption of the Washington Consensus favoured by the IMF and World Bank. Stabilisation was deemed a necessity in Hungary and Poland, where state budget deficits had grown rapidly and foreign debts had become larger than the countries' capacity to service. Several experts introduced a stabilisation programme, known as a shock therapy, whose aim was to achieve external and internal balance. It was argued that "one can't jump over a chasm in two leaps" [Marie Lavigne, 1995: 117–119, 121].

Many foreign advisors were often under contract to international financial institutions and bilateral or multilateral technical assistance programmes. These advisors favoured free trade and exchange rate convertibility rather than protection and capital controls. They supported aggressive privatisation without restructuring. The exception was found in East Germany where the "Treuhand" (Trust Agency) prepared state owned enterprises at a considerable cost to the government [Michael Kaser, 1995: 122–123]. By that time several programmes had been established under the auspices of the European Union, such as Phare and TACIS. Other donors, including the USAID, the UK Know-How Fund, the UNDP and the IMF, the World Bank, the EBRD and the KfW, which also provided loans for stabilisation, structural adjustment, industrial restructuring and social protection.

Technical assistance was delivered through the exchange of civil servants and by management consultants, including Agriconsulting, Atos, COWI, Ernst & Young, GOPA, GTZ, Human Dynamics, Idom, IMC Consulting, Louis Berger, NIRAS, PA Consulting, PE International, Pohl Consulting, PwC, and SOFRECO.

There had been an expectation that the introduction of current account convertibility and foreign trade liberalisation would force a currency devaluation that would support export-led growth [Marie Lavigne, 1995: 130–135]. When the prices were de-controlled, enterprises and retailers raised prices, as their main aim was to match those prevailing in the black markets, or reach

the world price levels. Responding to these price changes, consumers reduced their purchases and started buying better quality imported goods in place of domestically produced goods. This resulted in falling sales that led to the collapse of many enterprises, with personal layoffs or reduced hours of work and pay. Such situations further reduced effective demand. As imports grew and exporters failed to respond to opportunities in world markets due to the poor quality of their products and lack of resources for investment, the trade deficit expanded, putting downward pressure on the exchange rate. Many wholesalers and retailers marked prices according to their dollar values and the falling exchange rate fed inflation. The central banks in several countries raised interest rates and tightened credit conditions, depriving state agencies and enterprises of working capital. These in turn found paying wages on time impossible, which was dampening effective demand further [Marie Lavigne, 1995: 130–135].

The economic situation in the countries where economies were in a transition process declined much more than it was expected. The decline in output lasted until 1992–1996 for all transition economies. By 1994, the economic output had declined across all transition economies by 41% compared to its 1989 level. The Central and Eastern European economies began growing again around 1993, with Poland, which had begun its transition programme earliest, emerging from the recession in 1992. The Baltic States came out of the recession in 1994 and the rest of the former Soviet Union countries around 1996. The inflation remained above 20% a year (except in the Czech Republic and Hungary) until the mid-1990s. Across all transition economies the peak annual inflation rate was 2,632 percent (4,645 percent in the CIS)<sup>1</sup>. The unemployment increased and wages fell in real terms, although in Russia and other CIS economies the rate of unemployment recorded at employment exchanges remained low. Labour force surveys carried out by the International Labour Organisation showed significantly higher rates of joblessness and there was considerable internal migration [Simon Clarke 1998: 40–41, 49, 53; J.L. Porket, 1995: 98–100, 117]. High interest rates induced a “credit crunch” and fuelled inter-enterprise indebtedness and hampered the expansion of small and medium-sized enterprises, which often lacked the connections to obtain finance legitimately [Marie Lavigne, 1995: 130, 146, 150–154].

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<sup>1</sup> IMF staff estimates in Stanley Fischer, Ratna Sahay and Carlos Vegh, *Stabilization and growth in transition economies: The early experience*, April 1996, IMF Working Paper WP/96/31, Table 2, p. 8; UNDP, *Human Development Report for Central and Eastern Europe and the CIS*, 1999, New York: United Nations Development Programme, Table 2.1, p. 14

Several economists argued that growth performance in transition economies stemmed from the low level of development, decades of trade isolation and distortion in the socialist planned economies. They emphasised that transition strategies adopted reflected the need to resolve economic crisis besetting the socialist planned economies and the overriding objective was the transformation to market economies rather than the fostering of economic growth and welfare.

In 2000, the EBRD reports state that the effects of the initial starting points in each transition economy on the reform process had faded. The foundations had been laid for a functioning market economy through sustained liberalisation, privatisation, openness to international trade and investment, and the establishment of democratic political systems there remained institutional challenges. Liberalised markets were not necessarily competitive and political freedom had not prevented powerful private interests from exercising undue influence [EBRD 2000: 13].

Ten years later, in 2010, Transition report EBRD was still finding that the quality of market enabling institutions continued to fall short of what was necessary for well-functioning market economies. Growth in the transition economies had been driven by trade integration into the world economy. But such growth had proved volatile and the EBRD considered that governments in the transition economies should foster the development of domestic capital markets and improve the business environment, including financial institutions, real estate markets, as well as transport and communications infrastructure. The EBRD expressed concerns about regulatory independence and enforcement, price setting, and the market power of incumbent infrastructure operators [EBRD 2010: 2–5].

Income inequality, which can be measured by Gini coefficient, rose significantly in the transition economies in 1987–1988 and the mid-1990s. With income inequality, there existed poverty re-emergence between 20%–50% of people living below the national poverty line in the transition economies. The United Nations Development Programme calculated that overall poverty in Eastern Europe and the CIS increased from 4% of the population in 1988 to 32% by 1994 or from 14 million people to 119 million [UNDP 1999: 20–21]. Unemployment and rates of economic inactivity were still high in the late 1990 according to survey data [EBRD 2000: 103].

The year before the global financial crisis, the index of GDP had reached 112 compared to 100 in 1989 for the transition economies. In other words, it took nearly 20 years to restore the level of output that had existed prior

to the transition. The index of economic output (GDP) in the countries of Central and Eastern Europe was 151 in 2007, for Balkans and South-Eastern Europe the index was 111 and for the Commonwealth of Independent States and Mongolia it was 102. Several CIS countries in the Caucasus and Central Asia, as well as Moldova and Ukraine had economies that were substantially smaller than in 1989 [EBRD 2008: 13].

The global financial crisis (2008–2009) and the Eurozone crisis (2011–2013) destabilised the transition economies, reduced their growth rate and increased unemployment. Such slowdowns hit government revenues and widened fiscal deficits, but almost all transition economies had experienced a partial recovery and had maintained low and stable inflation since 2012 [EBRD 2013: 99–105].

The transition trajectories have varied considerably in practice. Several nations have been experimenting with market reforms for several decades, while others are relatively recent adopters. In some cases, reforms have been accompanied by political upheaval such as the overthrow of a dictator, the collapse of the government, a declaration of independence, or integration with another country. In other cases, economic reforms have been adopted by incumbent governments with little interest in political change.

The transition trajectories have varied considerably in practice. Some nations have been experimenting with market reforms for several decades, while others are relatively recent adopters (e.g., Macedonia, Serbia, Montenegro and Albania). In some cases, reforms have been accompanied by political upheaval, such as the overthrow of a dictator (Romania), the collapse of a government (the Soviet Union), a declaration of independence (Croatia), or integration with another country (East Germany). In other cases, economic reforms have been adopted by incumbent governments with little interest in political change (China, Laos, Vietnam) [Vuong, Vuan-Hoang, 2010]. The transition trajectories also differ in terms of the extent of central planning being relinquished (e.g. high centralised coordination among the CIS states) as well as the scope of liberalisation efforts being undertaken (e.g. relatively limited in Romania). Some countries, such as Vietnam, have experienced macro-economic upheaval over different periods of transition, even transition turmoil [Napier Nancy K., Vuong Quan Hoang, 2013].

According to the World Bank's *10 Years of Transition* report, «... the wide dispersion in the productivity of labour and capital across types of enterprises at the onset of transition and the erosion of those differences between old and new sectors during the reform provide a natural definition of the end of transition.» [The International Bank for Reconstruction and Development/

The World Bank 2002 pp. xix, xxxi]. According to the EBRD, a well-functioning market economy should enjoy a diverse range of economic activities, equality of opportunity and convergence of incomes. These outcomes had not yet been achieved by 2013 and progress in establishing well-functioning market economies had stalled since the 1990s. On the EBRD's measure of transition indicators, the transition economies had become "stuck in transition". Price liberalisation, small-scale privatisation and the opening-up of trade and foreign exchange markets were mostly complete by the end of the 1990s. However economic reforms had slowed in areas such governance, enterprise restructuring and competition policy, which remained substantially below the standard of developed market economies [EBRD 2013: pp. 8, 13].

Inequality of opportunity was higher in the transition economies of Central and Eastern Europe and Central Asia than in some developed economies in Western Europe (except France, where inequality of opportunity was relatively high). The highest inequality of opportunity was found in the Balkans and Central Asia. In terms of legal regulations and access to education and health services, inequality of opportunity related to gender was low in Europe and Central Asia but medium to high in respect of labour practices, employment and entrepreneurship, and access to finance. In Central Asia women also experienced significant lack of access to health services, as was the case in Arab countries [EBRD 2013: pp. 6, 78–96]. While many transition economies performed well with respect to primary and secondary education, and matched that available in many developed economies, they were weaker when it came to training and tertiary education [EBRD 2013: pp. 6].

Over the decade from 1994 to 2004, the transition economies had closed some of the gap in income per person with the average for the European Union in terms of purchasing power parity. These gains had been driven by sustained growth in productivity as obsolete capital stock was scrapped and production shifted to take advantage of the opening-up of foreign trade, price liberalisation and foreign direct investment. However, the rapid growth rates of that period of catch-up had stalled since the late 2000s and the prospects for income convergence have receded according to the EBRD's prognosis, unless there are additional productivity-enhancing structural reforms [EBRD 2013: pp. 4, 8, 10–17].

To spur further economic reform and break out of a vicious circle, the EBRD Transition report 2013 proposed that the transition economies should: open trade and finance, which made reforms more resilient to popular pressures ("market aversion") and meant that countries could access the EU single market either as member states or through association agreements

(such as those being negotiated with Ukraine, Moldova and Georgia); encourage transparent and accountable government, with media and civil society scrutiny, and political competition at elections; invest in human capital, especially by improving the quality of tertiary education [EBRD 2013: pp. 5, 34, 38, 52–53].

## THE ROLE OF A STATE IN THE PROCESS OF TRANSFORMATION OF NATIONAL ECONOMIES

An active state's role in the economy does not by itself guarantee economic success in development or transition. The wrong active state policies can fail to achieve a goal. A state can become an institution that is a parasite on society and obstructs economic progress. However, when the state just stands aside, waiting for individual action and non-state forces such as entrepreneurship, comparative advantage, and cross-border capital inflows to bring development or transition, the result is bound to be a failure. The extent of that failure is potentially even greater for transition than for development. For development, the failure tends to produce stagnation, with the country locked into its unfavourable position in the world economy. For transition, the consequence of fully adhering to the neoliberal strategy can be a rapid movement backwards, with economic and social collapse in the worst case.

The state is the only institution in society that is in a position to guide a transition from central planning to a market economy. Unlike individuals, the state can formulate the goal of transforming the economic system and then undertake the steps necessary to accomplish that transformation. To do so it must create conditions that channel the profit motive of individuals into productive ends. The appropriate state's role includes, at least, the following: assuring that adequate low-cost financing is available for market-oriented productive activity; assuring growing aggregate demand; investing in the infrastructure necessary for the new patterns of production and trade that will develop in a market economy; and protecting domestic industries from superior foreign competition at least for a certain period of time

To ensure the well-functioning market economies, governments need to perform their optimal function that in turn can establish and enforce the rules of games, promote social objectives, raising revenues to finance public sector activities, spend revenues productively, enforce contracts and protect property, and produce public goods. They also need a pared down

set of regulations that are clear and leave little margin for interpretation or discretion. While the guiding principle under central planning was that nothing was permitted unless explicitly authorised, the guiding principle in a market economy should be that everything is permitted unless expressly forbidden. States' role in this process is very important, because they can play an active role in the development of social, financial, macro-economic stabilisation, and foreign trade policy spheres.

An effective government in fact is a precondition of transition to a market economy. There are three main reasons for this. **First**, voluntary transactions cannot take place in an institutional vacuum. The well-known fact about a market economy is that it cannot exist without legal, administrative, regulatory and attractive institutions maintained by a state. Institutions are needed to conduct the following functions: enact a system of laws, enforce contracts, collect taxes, oversee banks, supervise corporate entities, promote and preserve competitions, supply entrepreneurs with information that reduces uncertainty, cuts transaction costs and secure private sector confidence in decision making process on investment opportunities.

**Second**, market institutions can't spring up automatically. There is a belief that market institutions would spontaneously emerge from voluntary transactions between economic agents if the state stands aside. This has never happened before and we have no reason to believe that it is going to happen now. Market institutions, in a sense, represent the essential, irreducible minimum of "public goods" that must be provided if markets are going to work at all [Garnaut, Ross, 1991]. Since they are public goods, people are unlikely to cooperate voluntarily with one another to provide them, just as they would not in regard to the provision of other kinds of public goods. Of course, if the state does not provide market institutions, private economic agents would have to develop some informal rules to stem uncertainty and introduce some levels of predictability into commercial transactions. In the absence of state intervention, however, these agreements are likely to evolve into pacts that neglect the interests of consumers and small producers and reflect only the preferences of those who possess economic power. Thus, as regards "public goods", market institutions initially have to be brought about by non-economic forces.

**Third**, the market transition is not a consensual but a conflictual process. A market economy is not just embedded in state institutions; it also has its ideological and moral basis, which is what the economy in transition is lacking. Neoclassic economists' trans-historic assumption about the human motivation may enable them to generate sophisticated models, but the

simple fact is, as Leiberstein points out, that people's behaviour has often been influenced by "habits, conventions, work ethics, partial calculation, and inertia" [Arndt, Heinz W., 1988]. When a great institutional change occurs, they often find it hard to adapt. In the case of market transition, people would not accept market values and behave according to market rules simply because the government has announced that their country has adopted the model of market economy. It took a long time for European countries to develop attitudes favourable to the formation of market systems in the eighteenth and nineteenth centuries, because, violating the "moral economy" that had pre-existed the market economy, practices most consistent with market rationality caused a great deal of confusion and disturbance in those societies [Thompson, E. P., 1971].

In transition economies, the essential part is the creation of new institutions, systems and laws:

- **Laws** that determine the private ownership rights, regulate contracts/agreements, corporate organizational and bankruptcy procedures;
- **Tax paying systems** that are based on strictly defined rules and regulations;
- **Other systems**, especially those that strictly determine the obligations and rights of accounting;
- **Information Systems** (accounting, audit of the system of national accounts).

States' economic role and position may radically change during the transition phase, because it is important to set up strictly centralised state regulation and form a completely new system of economic management. This can be achieved only through the elimination of a state's domination over the economic system, strengthening privatisation processes, fostering competitive relations, creating new marketing-institutional environment, and harmonising interests. It is true that the government's dominating power should be eliminated but establishing new marketing-institutional environment and market culture should be developed only under the state's active legislative, coordinative and stimulating control.

In order to assess a state's economic role, it is important to consider its involvement in the economy, its regulating degree, its efficiency, optimisation of the state's role, how it responds to historical challenges and needs for development. For determining the efficiency of state regulation, first of all, it is important to check the correspondence of the acquired results with set goals and the expenses needed for it (It is important to reduce them). Yet, the government is the only subject of society in the modern world that can coordinate the transformation of the state. Its participation and influence of economic processes are of crucial importance.

The basic objective of a state's participation in national economic administration is the realisation of economic potential and initiation of favourable conditions and institutions for the development of a new system. The process of selection and approbation of indirect regulation mechanisms is under way during a transformation period. At the starting stage they are not as important; their importance only increases in the course of development of market relations. Later, when the methods of indirect regulation achieve their results and become sufficiently stable, they have a preference in comparison with the direct methods, as they do not contradict the basic regulator – market mechanism but supplement and enrich it.

The structural and institutional transformation of the economy is a long process. If it is well organised and purposeful then it is the unity of concrete, coordinative events initiated by the state. The implementation of institutional reforms implies creating market institutions on every level of the national economy. The institutions at the macro level have more significance as they control the internal market and the whole system itself. The institution of private ownership is most important, because it regulates the independence of making economic decisions of subjects operating on the market, their liabilities and obligations, stimulation of reduction of expenses and rational utilisation of resources. The practice of economic transformation in transition countries has proved that the absence of an institutional component increases informational indefiniteness, raises the risk of failure during exchange processes and signing contracts. All these increase economic, social and transactional expenditures of goods and services. A market cannot operate without an institutional environment. The basics of building and developing modern institutions lies in the correlation of contracts and agreements, which cuts down the informational indefiniteness and risk rate, provides firm guarantees and decreases transactional expenses.

In a transition period, a state has responsibility for achieving a sustainable economic growth. State authorities have to pay attention to macro-economic stability, financial budgeting, taxation and monetary systems. Developing international trade relations with developed nations and reducing social risks also play important roles.

One of the main problems that arise in a transition period is the macro-economic instability, which is an ordinary phenomenon. During a transition phase any country's peculiarity is its global instability. This determines the macro-economic problem, which should be solved during the transition – this is structural-investment transformation on technical- technological bases. Urgent solving of this particular issue determines the objectives at

the macro levels of the economic transformation that the country and its institutions face. Macro-economic instability, which has many different forms, has emerged as a result of a combination of past and present reforms, of their objective and subjective influence.

The preliminary conditions of countries in transition can significantly vary. The difference can be in the degree of macro-economic instability. The instability can be revealed in the budget and foreign trade deficit, foreign debt, limited currency reserves, considerable losses in the banking system and state enterprises.

A stabilisation policy solves the problems that need an immediate action, such as inflation, unemployment, instability of a state budget, where monetary and fiscal policy is used. The structural adaptation concerns the issues of long-term economic growth, namely disorder in the production economy, control of prices, interest rates and exchange rate, tough customs tariffs and quotas, and the introduction of taxes and subsidies. The coincidence of the implementation of above-mentioned activities is crucially important for a transition economy.

A short-term stabilisation policy should be supplemented with the structural reforms in the spheres of budgeting and finances, monetary-fiscal and foreign economic affairs, as well as systemic reforms in ownership relations, enterprises, prices and labour market. Long-term perspectives of stabilisation can be provided only in case there are indirect mechanisms of macro-economic control.

A state can achieve macro-economic stability in a transition period with correct transformation of financial budgeting, and taxation and monetary systems. Monetary, budgetary and price policy related issues are of vital importance for transition economies, because their realisation on time can determine rapid economic development, minimisation of inflation, decrease in unemployment, and settlement of the social problems in the country. According to the above-said, during the market economy formation process it is crucial to work out a new approach to a state financial system's key entity – the budget, balance budget receipts and outlays, identify the real deficit limits, improve the taxation system, enhance enterprises, monetary policy regulation and management related issues.

For socio-economic development of the country, structural transformation of the economy and speedy stabilisation processes, it is significant to cleverly analyse the basics of budget formation, income sources and channels, mechanisms of their creation and utilisation, and rational involvement of a country's leading political and economic potential.

The hardest objective of the transition economy budgeting is the stabilisation, which is so essential for unhampered reforms, by means of strengthening the set of budgetary policy instruments. A budget should serve as an impetus to the revival of the economy, especially the private sector growth and influence on the advance of economic and administrative infrastructure. Because it is practically impossible at the first stage of the transition to completely transform the activity of budget authorities and especially of the tax system and budget planning, the formation of a budgetary policy should be taken into account. Moreover, the structural transformation of the budget should be done step by step, so that not to impede state revenue receipts and maintain their key functions. It is important to work out temporary instruments for a short-term budgetary policy in order to achieve economic stabilisation, gain time and later make desirable changes in instruments, which will remain long-term.

Structural transformations set forth the issues of social justice that should by all means be considered at early stages of a transition period. Besides, in countries where sensitivity towards social justice and harmony is high, special taxation measures should be exercised for the achievement of a consensus and successful implementation of reforms.

The abandonment of centralised control by the market economy raises the necessity of new approach towards a budgetary policy. Certain steps can be taken immediately in frames of a tax policy. Firstly, for the rapid growth of the private sector, a tax reform should exempt it from discriminatory taxes, which will be substituted by imposing penalties. It is also of great importance to cut down taxes according to their categories, not to provide any special benefits to anyone, and introduce equal rules for all of them. Also it is crucially important at an early stage of the transition, which is accompanied by a high level of inflation, to take security measures for budget receipts. At an early stage, the budget should be used as a key instrument for economic stabilisation: to reduce liquid funds, at least to prevent their additional growth, and provide necessary resources for the recovery of different economic sectors.

The structure of tax managing authorities should change to facilitate the accomplishment of tasks, which involve new procedures of sanctions. Several years are needed for structural modifications, as far as it requires overall reorganisation, selection and retraining of appropriate staff. For the strengthening of tax authorities, it is essential to take decisive steps. It is important to create more effective control systems to fill the gap, which remains after the modification of central planning. It is also important to set

up an adequate system for stimulating government officials. It is likely that initial adjustment of prices will lead to significant decrease in salaries. Under such conditions, in order to reduce corruption and stimulate tax collectors, it is important to use such special mechanisms as paying premiums or bonuses for the tax amounts collected by them.

Budget authorities should work out special mechanisms for balancing budget outlays and not rely on planned decisions. As this will need certain amount of time, which will make irrational utilisation of resources possible, at an initial stage it is important to toughen control on expenses and their records. Since bureaucratic elements have different opinions about their responsibilities, it is possible to create chaos, which can negatively affect the budget expenditure policy in such significant spheres as exploitation, services and social security. Reorganisation of the existing systems of social maintenance and social assistance, creating new facilities for the population and development of their professional skills, and reactivation of the social security system are needed against probable constraints. Envisaged budget constraints and market principles for determining salaries should define the distribution of maintenance in favour of the socially unsecured. This will encourage the reorganisation of existing administrative mechanisms, which will be orientated towards distributing assistance.

While shifting to a market economy it is important to transform institutional practice of deficit financing and cash management. As cash inflows are not automatically sterilised, the budget cannot be financed by means of money emission with the help of savings. Such a strict budget constraint forces official bodies to change the work practice. Because the difference between a deposit rate and a loan rate is significant and the government is obliged to pay much more on its own loans, the practice of keeping big amounts on bank accounts, by those bodies that owe much to banks, will become inefficient. Efficient capital management is necessary for reducing expenditures. Moreover, it is important to eliminate the practice of accumulated unsettled debts by different public enterprises and organisations.

At an early stage of transformation, the structure and amount of budget outlays are not formed according to the demands of the country, but according to the financial position of the country. As a result, the budget should be drawn up to be socially-oriented. One of the concerns of a budgetary policy is to clarify the priority of financing expenses from the budget. Obviously, a state cannot finance every sphere of socio-economic activity equally. Thus, the priorities of financing expenses should be defined and proved, which the state will undertake for a certain time. Preference should be given to

such fields as economics, state investments, defence, social infrastructure, education and science. Furthermore, the expenses of legislative and executive bodies should be cut down.

The main direction of a budgetary policy is the reduction of the budget deficit by rational organisation of budget receipts and outlays. Thus, among budget activities, the most important thing to do is to work out the deficit financing system. In order to overcome the budget deficit, a state should take care of the constant growth of finances by improving the economy, expanding production and raising efficiency. Banks should not finance a budget deficiency, because it can result in the development of inflation and negatively affect investment processes.

A government can also issue securities (bonds, short-term bonds, treasuries, etc.) and distribute them among banks, enterprises and society, intended for the growth of budget receipts.

While shifting to a market economy it is important to transform the institutional practice of deficit financing and cash management. As cash inflows are not automatically sterilised, the budget cannot be financed by means of money emission. Such a strict budget constraint forces official bodies to change their work practice.

For effective solving of a state financial and monetary policy, its strategic and tactical objective of greatest importance is the management and regulation of state debt. As a result, successful mechanisms of managing domestic and foreign debts should be established and put into practice, which is not exercised yet in most transition countries. The main concern of foreign debt management should be gaining benefit from foreign finances, providing macro-economic stability and maintain payment and consumption. To achieve this, a state should well consider the relationship among investments, economic growth and foreign loans. However, appropriate legislative and methodological documentation should be created for managing domestic debts.

A state should pay attention to the process of shifting to an open economy, the directions of a foreign economic policy, and studies on the influence of foreign investments on economic growth, and the problems of regulating exchange rates. One of the objectives of a state transition economy is to make favourable conditions for national economic integration into the world economy, international economic unions and organisations. Consequently, the country will be able to participate in international labour distribution processes resulting in efficient growth of the national economy.

Reforms also require the introduction of national and foreign currency convertibility, amendment or elimination of tariff barriers, and reduction

of tariffs, and liberalisation of investment laws. The success of the above-mentioned reforms depends on the government's willingness to foster international trade and capital participation on international markets. International trade facilitates the adjustment of reasonable prices, expansion of the market and makes available foreign technical and technological achievements to firms and individuals.

To facilitate domestic demand limitations, a government should change the national currency rate. The introduction of more devaluated rate can lead to the decrease in demand on imported goods and increase competitiveness of exported goods. The devaluation of currency should be pursued at the first stage of reforms. Although, inflation expected at this stage due to uncontrollable prices can easily defeat competitiveness achieved through devaluations. Devaluations can also hamper credit availability and reduce money supply, thus supporting strict monetary–fiscal policy.

Together with the establishment of currency rates, it is important to provide convertibility of the currency for economic openness, world price impacts and usage of international competition benefits. Besides, currency convertibility promotes transnational corporations to provide transition countries with modern technologies, knowledge management and business and expand trade relations with them. The transnational corporations' interest in transition countries results from the following: a low price of the working force and a guarantee of their beneficial position in a potential market.

Although the majority of governments of transition countries support the direct inflow of foreign investments, western firms do not hurry to invest capital in them due to inconvertibility of their currencies, political instability and the absence of appropriate financial structure.

The reason for foreign investment hampering in countries in transition is: the absence of legislation defending the interests of transnational corporations; a heavy and time consuming bureaucratic system; destroyed infrastructure; low work productivity resulting from low value of labour power.

It is important to gain foreign financial aid for transition countries to provide currency reserves, create infrastructure and stabilise their economies. In Eastern European countries and the CIS countries, foreign financial assistance is used to facilitate economic stabilisation, balance taxation, create new infrastructure, establish new companies and improve firms' productive base.

Finally, because the optimal role for government derives not just from economic considerations but also from the interplay of political and economic forces, the views of the executive branch of the government should broadly

match those of the legislative branch. If the two sides are miles apart on what the government should do, as they have been in Russia and some other countries, neither an optimal government role nor rational policies are likely to emerge.

## CONCLUSIONS

The transition, within its classical definition, means that the market, by itself, is a central mechanism of resource allocation. In transition, we should avoid, what Galbraith calls “simplistic ideology” [Galbraith, John K., 1990], what Przeworski calls “neoliberal fallacy” [Przeworski, Adam, 1991], or what Kornai calls “uncritical, mythical cult of the market” [Kornai, Janos, 1992]. The market is not a panacea for all our socio-economic problems. Nor is it a neutral, natural, apolitical, and ahistorical institution. Moreover, the market is not an end in itself. Rather than that, it is just a means to promote social and individual welfare. For this reason, the potential role of non-market means, including state intervention, in improving welfare should be neither dismissed nor underestimated.

Any government intervention in the life of market is caused by default or design. In the modern world, less government intervention does not produce welfare for people. This happens in those countries where their huge role was played in the structural adjustment on economic, where international competitiveness was much stronger, economic growth was more sustained and distribution of income and wealth was equal [Katzenstein, Peter, 1978].

In the recent period, despite the influence of neoliberal ideas, the state's main directed strategy is the only effective way to undertake economic transition or economic development. Yet, it appears that the latter type of strategy, despite its effectiveness when it is carried out, tends to be self-undermining. Wealthy and powerful social actors will eventually push for a shift to a neoliberal strategy. They are aided in this objective by the influence of the neoliberal ideology.

At the general level, economic policy, chosen by a government seems to be the most important for achieving sustainable growth in a transition period. This includes a stable macroeconomic environment, generalised access to the world economy, protection of property rights, and spending on public goods that provide benefit to all. A crucial question is why governments do not pursue these sound policies. The lack of knowledge may be a part of the

answer. Sound economic principles do not translate precisely into unique policy packages, but need to be adapted to the specific economic and social realities.

The lack of incentives seems to be much more important. What should be done to give the right incentives to a government of developing countries, short of waiting until they become mature democracies? A practical answer to this question is that there are beneficial complementarities with political and economic liberalisation. Political liberalisation facilitates opening up the economy to international competition, probably because democracy increases the political influence of those that are more likely to benefit from international integration. But economic liberalisation seems to be a necessary step towards economic success: new democracies do not prosper without it.

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## STATE'S ROLE AND METHODS OF IMPACT ON ITS ECONOMY IN A TRANSITION PERIOD

### Abstract

The article discusses the transformation process and state's economic role in the transition period. The article also deals with the main objectives and goals of state regulations, the peculiarities of countries' socio-economic formation and procedures of institutional transformation. A government's role in economic development is changing during the transition period. The main important issues that must be set are strictly centralised state regulations and forms that are completely new systems in economic management, which should be achieved through the elimination of a state's domination over the economic system, strengthening a privatisation process and so on. It is true that the government's dominating power should be eliminated but establishing a new marketing-institutional environment and market culture should be developed only under the state's active legislative, coordinative and stimulating control.

The theoretical basis of the article represents the researches of foreign scientists, economists and international organisation. The methodological basis of the article is based on economic analysis, comparison, and grouping methods. While preparing the article, modern experimental methods and model of macro-economic researches, as well as researches and statistical data, approaches and methodology of several international organisations were widely used.

**Keywords:** international institutions, transition economies, economic growth, economic integration, state's role