Economics of Transition in General Economic Theory

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Abstract

This paper examines hypotheses concerning the theory of transition from Communism to the market. It generalizes historical practice by separating forms (types) and stages of transition. The components of transitional process are classified as parts of Transition Economics: Microeconomics of Transition, Macroeconomic of Transition, International Economic Integration, Safety Net of Transition, and Role of Government. These parts are closely intertwined and taking together they completely describe the transitional process in all transition economies.

Key Words: Objectives; Discussions; Theoretical and Practical Aspects.

1. Introduction

In Georgia, as in any other country with a transition economy, economic reforms are aimed to enhance the success of market economy. Reforms in the educational system have a special meaning, because they deal with the development of civil society. The education system includes the institutions that helps set and enforce the rules that allow market transactions to proceed in a climate of confidence with decrease the opportunities for corruption and crime. It is beyond dispute that education is a key to economic development, because of its direct effect on productivity and because those who are more educated are more receptive to new ideas. Questions still, however, remain about the organization of educational process and particularly, about our curriculum and contents of our courses according to the new market demand. Among others, one course has a special meaning. This is Economics of Transition, which may answer many issues hotly debated nowadays. For example, should economic reforms in transition countries be fast or slow? How important are reform policies relative to initial conditions? Is privatization really vital, and does it matter how it is done? How can countries build institutions to support efficient market systems? To answer all such questions, the Economics of Transition should be developed.

The second argument for its development is as follows. As the old socialist system collapsed, a new system had to be put in place. But policy makers, both within the transition countries and the international economic institutions (such as IMF and WB) did not have the luxury of waiting for more information and knowledge. Some transition economies developed their own approaches to transition; others were heavily dependent on the advice of external advisers. It is important to appreciate the fact that transition has been fundamentally "learning by doing". Since, prior to the present transitional era, there was little theory and even less experience. None of modern theories, including neoclassical theory and new Keynesian theory, provides an adequate underpinning for understanding maintenance and particularities of transitional economies.

On another hand, there is a strong base for the development of Transition Economics.

Transition countries differed substantially in their initial conditions, which include the level of income and wealth, the nature and extent of economic distortions, and the level of institutional development. However, economists who investigated the transitional experience of countries of Central and Eastern Europe (EE) and the former Soviet Union (FSU) found strong common patterns for countries at similar stages of stabilization, despite differences in initial conditions.[1]

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As in any economic theory, the Economics of Transition may provide background for expertise social and economic programs before their implementation to avoid mistakes.

The paper is organized as follows. In section 2, the essence and distinctive components of transforming process are analyzed; section 3 reviews two stages of transition period. Section 4 analyzes the contents of macroeconomics of transition as a part of general economic theory. Section 5 concludes the paper.

2. Transition: Types, Contents, Particularities.

As mentioned above, The Georgian economy is an economy of the transitional type. Under transition economists mean a specific period in economic history of a country when one economic system (models or methods of production) is replaced by another. For instance, the fall of the Roman Empire or the decline (or retrogression) of Medieval economy revealed an example of transitional period that has been written as dramatic pages in economic history of mankind. Similar story may be told about the turbulent arrival of capitalism in the 18th century.

According to the World Bank classification, there are some types of transitional economies[2]:

- Industrial post Soviet model,
- Latin America model (Latin America, Near East, North Africa, Philippines) ,
- African countries model (located to the south of Sahara),
- Asian agrarian model.

Russian economists add to this list one more model - industrialized countries model where the transition from industrial to postindustrial societies[3] occurs.

So, transition period means a specific period between old and new economic systems, or the period that is on the junction of old and new methods of production or on the butt of old and new societies. Transition period occupies a special stage in economic history of a country although the long-term goal of transition is the same as that of economic reforms elsewhere: to built a thriving economy capable of delivering long-term growth in living standards. As Austrian economist Joseph Schumpeter wrote, it is a period of "creative destruction". [4]

Each type of transition has its distinctive pattern that depends on initial and final points of movement. In FSU countries like Georgia, the character of transition, its goals and contents are absolutely different comparing to others types. The crucial point is that it is not just the adoption and/or modification of new policies or programs, but a passage from one mode of production to a different one. In fact, there is a movement from socialism to capitalism. Hence, transitional reforms must penetrate to the fundamental rules of the game, to the institutions that shape behavior and guide organizations. It makes it a profound social transition as well as an economic one. For example, in Latin America countries liberalization usually means eliminating price controls and relaxing trade protection in a few heavily regulated or protected sections. Liberalization in post Soviet transition countries faces an unprecedented and more daunting task, that of freeing not only the terms of market transactions but transactions themselves: abolishing state orders and

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[1] For example, see: Martha de Melo, Cevdet Denizer, Alan Gelb (1996), From Plan to Market: Patterns of Transition, Policy Research Working Paper #1564

[2] World Bank, From Plan to Market: World Development Report 1996.

[3] See, for example, Красникова Е.В. (2006) Экономика переходного периода, p.25.

[4] http://en.wikipedia.org/wiki/Creative_destruction

procurement, state production and trading monopolies, and the centralized allocation of foreign exchange. Liberalization also means freeing entry into production, services, and trade, including the freedom to open a new business, to expand or break up an existing business, and to change product mix, supplies, customers, or geographical base.

Another hotly debated issue is the relationship between economic liberalization and political freedom**.** From the cross-country evidence, it is quite clear that in EE and the FSU, there has been a close relationship; in other words, economic reform has been led by political change, and generally, where the political change has been sharpest, the economic reform has also been sharpest. There are several reasons for this. One theory that was developed by Mr. Balcerowicz is that a sudden political change created a window for reform, during a period of extraordinary politics[5]. This allowed reforms to proceed much more rapidly that they normally would in a political environment where political groups oppose any type of radical reform. The opinion polls in these countries also suggest that on the level of individuals there is a close relationship between attitudes toward political reform and economic reform. This might be specific to these transition countries and does not necessarily prevail in other countries around the world.

I agree that "the reduction of output that occurred in EE and FSU states should be considered as the exceptional case in the world economic history. Never and nowhere… there occurred such a dramatic decline in output, living standards and life expectancy without extraordinary circumstances, such as wars, epidemics, natural disasters."[6]

3. Stages of Transition.

After more than fifteen years of performance, the transformation process acquires its history. Now we may separate the transformational recession (the deviation of actual output from potential) from the process of economic growth (recovery from the transformational recession).

Transformational recession. The post Soviet countries, after restoration of their independence in the beginning of 1990s, fell into a deep economic recession with national output and employment contracting dramatically – by about 50% -70% and more, and as compared to the highest pre-recession level of 1989, investment dropped even more, income inequalities rose greatly, so that real incomes declined dramatically for the majority of the population, death rates increased by about 50%, whereas life expectancy declined markedly. This is comparable with the Great Depression (1929-33), when GDP in Western countries on average fell by some 30%. Economists call this period as "Great Transitional Depression".[7] Only in China and Vietnam there was no transformational recession at all – on the contrary, from the very outset of reforms economic growth accelerated.

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[5] Бальцерович Л.(1999),Социализм, капитализм, трансформация.

[6] Popov Vladimir, Shock Therapy Versus Gradualism Reconsidered: Lessons from Transition Economies after 15 years of Reforms.

[7] In Russia output fell by 45% in 1989-98, death rates increased from 1% in the 1980s to 1.5% in 1994 and stayed at this high level thereafter, which was equivalent to over 700,000 additional deaths annually. Over the period of several years such population losses could be likened to the impact of the WWII. By way of comparison, during the Second World War, national income in the USSR fell only by 20% in 1940-42, recovered to its 1940 level in 1944, fell again by 20% in 1944-46, during conversion of defense industry, but exceeded its 1940 level nearly by 20% already in 1948. In some of the former Soviet states that were affected by military conflicts (Armenia, Azerbaijan, Georgia, Moldova and Tajikistan) GDP in 2000 was only 30 to 50% of its pre-transition levels.

The question of theoretical discussions is whether reduction of output during transition should be viewed as a result of supply side or demand factors. One view, usually referred to as Keynesian, is that transformational recession was caused by the reduction of demand that occurred during the liberalization of prices, the introduction of convertibility and the subsequent stabilization. This approach considers recession as a demand-pull phenomenon and the result of overshooting. It is said to be caused by the demand shock, which was generated by the transition to the market and by the restrictions imposed by fiscal and monetary authorities It has been argued, for instance, that the impact of demand-side factors on output decline in Poland has been much more pronounced than the impact of supply-side factors. [8]

Another explanation is that the collapse of output during transition can be best explained as adverse supply shock caused mostly by a change in relative prices after their deregulation, due to distortions in industrial structure and trade patterns accumulated during the period of central planning, and by the collapse of state institutions during transition period.[9] This alternative explanation of the collapse is based on three groups of factors which caused reduction in output. First, by the adverse supply shock that resulted from deregulation of prices and change in relative price ratios that created the need for reallocation of resources due to distortions in the industrial structure and external trade patterns that existed before transition. Second, by another adverse supply shock associated with the collapse of state institutions (understood as the ability of the state to enforce its rules and regulations), which occurred in the late 1980s - early 1990s and which resulted in chaotic transformation through crisis management instead of organized and manageable transition. And third, by poor economic policies, which basically consisted of macroeconomic mismanagement and import substitution, no matter whether the pursued reforms were gradual or radical.

Post-recession recovery. In most post communist countries, recovery began only by the end of the 1990s, when in most but not all countries GDP reached pre-recession levels. The process of recovery should be treated as a normal growth process: it could be modeled by using conventional growth theory. It should be stressed that factors that determine performance in the recovery period are different from the factors affecting performance during transformational recession. First, cumulative levels of liberalization achieved by 1995 appear to play a positive role at the initial stage of recovery (1994-98 in most post Soviet countries). At the subsequent stages the level of cumulative liberalization does not seem to be important but the progress in liberalization appears to affect performance positively. Moreover, there is a hypothesis that positive correlation between increases in liberalization and performance in 1995-2003 existed. [10]

4. Economics of Transition

The transition from a planned economy to a market economy involves a complex process of institutional, structural and behavioral change. This is a complex and comprehensive phenomenon. The analysis of transition process contains the following major directions:

- **Microeconomics of Transition** focuses on creating markets and market price mechanism through privatization

[8] Бальцерович Л.(1999),Социализм, капитализм, трансформация.
[9] Popov Vladimir, Shock Therapy Versus Gradualism : The End of the Debate (Explaining the Magnitude of Transformational Recession)

[10] Popov Vladimir, Shock Therapy Versus Gradualism Reconsidered: Lessons from Transition Economies after 15 years of Reforms

- **Macroeconomic of Transition** centers on creating financial systems, specifically financial infrastructure and developing a new fiscal role for the state through the budgetary process; reviews the debates about monetary and fiscal policy in transitional countries.
- **International Economic Integration** focuses on new trading arrangements and policies
- **Safety Net of Transition** (or the infrastructure and policies) is necessary for the provision of medical services, unemployment benefits, pensions, and the like.
- **Role of Governments** analyzes new government mission during the transitional process and the role of institutions at different stages of transition.

These five components of the transition process are closely intertwined, and taken together they completely describe the transitional process in all transition economies. Indeed, these components constitute the structure of a special part of Economic Theory – Economics of Transition that studies the transition from socialist planned economy to market oriented one.

Microeconomics of Transition.

The concept of transition implies deep restriction of the whole economic system. With restricting, when transition comes to an end, new institutions and policies are in place, they are functioning, and most important, they are influencing recourses allocation. In contrast to socialism that has state or, more generally, public ownership as a cornerstone of economic system, in market economy the fundamental mechanism for decision making about recourse allocation is based upon private ownership. Therefore, it is not surprising that privatization holds center stage in contemporary transition economies. Economically, privatization means a redistribution of equity rights from the state to individuals. Its fundamental objective is to change the way decisions are made by dramatic changing of the mechanism of allocation of resources... The allocation of resources will be directed by the forces of supply and demand and profit maximization. Previously repressed sectors, notably energy and services, expands and offsets declines in industry-especially in defense-related industry, given substantial cuts in defense procurement-and agriculture, which was heavily subsidized in many countries. Expansion of previously repressed nontraded sectors, including real estate, occurs despite large devaluations in exchange rates, which normally favor traded goods. Developments in the labor market reflect the changes in the composition of sectoral output, and especially the growth of small private trade and transport activities.

The "when" to privatize was quickly settled: the sooner the better, although the "how" really set the pace. The decision on what to privatize was also perfunctory: as much as possible. No distinction was drawn between regulated industries and competitive ones; although a few countries enacted but could not properly enforce antimonopoly laws.

The privatization process passed through several steps. It started out with the creation of agencies that oversaw the process of privatization, then the development of appropriate legislation and creation of the property fund (state agency of property) and state agency that would be responsible for identifying state properties was undertaken; distribution of shares was the next step, and etc.

Each country used some distinctive combination of three privatization methods: direct sale, mass privatization programs (often through vouchers and auctions) and management-employee buy-out.

The 1990s experience shows how difficult both privatization and regulation are. There is no universally appropriate reform model. Every restructuring and privatization program needs to consider explicitly the underlying economic attributes and technology of each sector and its institutional, social, and political characteristics.

While privatization is fundamental to transition, it is just the beginning. After ownership arrangements are changed, it is necessary to undergo restructuring. In most transition countries, restructuring has not fully occurred and state funds still find their way into enterprises, especially sectors such as heavy industry and defense. Moreover, hard budget constraints have not replaced soft budget constraints, the price system is not still flexible and meaningful, and there is lack of financial and capital markets.

Macroeconomics of Transition.

In most transitional economies, two fundamental issues require immediate attention:

! There were systems without traditional market-type set of market institutions and policies. Moreover, the concept of influencing economic outcomes through indirect policy mechanisms was alien to decision makers.

! With the collapse of the old order, the macroeconomic imbalances such as huge budget deficit, high level of unemployment, and inflation, including hyperinflation, are apparent.

Under these circumstances creating of macroeconomic institutions and policies is an inevitable element of transition. There are two components of the macroeconomic structure and financial system in any country – banking system and state budgetary system. The development of both components presents a fundamental challenge for the success or failure of transition process.

Revenues available to the state decreased much more rapidly then the willingness of the population to give up long-held state benefits such as pensions, medical care, and subsidized transportation. The usual response was a shift to new recourses of revenues, usually a Western-style taxation system relying upon value-added tax (VAT), individual and corporate income taxes, excise tax and the like. At the same time, the shift to the varying forms of "pay as you go" safety net provisions has been slow, and various types of directed credits injected into falling industrial enterprises have been sustained. Another typical result has been budget deficits, difficult to finance in noninflationary ways because of the absence of meaningful markets. Thus, the emergence of modern banking system has been the second critical component of the newly emerging macro economy.

The essence of banking in the transition setting has been the replacement of the socialist monobank system with a modern two-tier banking system consisting of a central bank and monetary authority and a net of commercial banks. The creation of a sound modern banking system has proven to be a daunting task in many transition economies. Indeed, the initial emergence of a large number of undercapitalized banks, and the shallow and nontransparent nature of financial markets, has limited the effectiveness of emerging macroeconomic policies and allowed the financing of the deficit through inappropriate and often inflationary mechanisms.

One of the most debated issues is still **Monetary and Fiscal Policy in Transitional Countries.** Let's discuss the main directions in these debates.

- ***Stabilization as a priority***

Porter, Gelb, Balcerowicz and others have argued that neither the effective functioning of markets nor renewed investment is possible with severe macroeconomic price instability; thus, stabilization becomes a priority for the resumption of growth. At the same time, it should be recognized that stabilization is rendered more difficult by severe output contractions during the early stages of liberalization; such contractions reduce potential tax revenues and raise claims on fiscal resources to cushion the effects. Stabilization is also rendered difficult by the absence of external financing and by the large depreciations in the exchange rate that accompany the early stages of liberalization.

- ***Big bang versus gradualist approach***

A continuing debate has been whether or not countries should follow a "big bang" or gradualist approach to reform. The advocates of the first approach believed that the faster a transitional country became a market economy, in particular, the faster it privatized, and the quicker this economy would be able to avail itself of the growth opportunities that the market provided. Others proposed a more gradual process of reform. The sale of government assets needed to be done more slowly, and the economy has to be liberalized more gradually. This school argued that there are large costs associated with very rapid adjustments and that there were large risks associated with it, for instance, privatization before certain institutional changes (the creation of legal infrastructure) have been put into place.

First of all, it is unrealistic to expect that a given regime had a very wide range of options. The countries' experience determines the conditions under which one or another kind of reform can work well. Transitional reforms do not proceed at the same pace. If government wants to bring inflation down from very high levels, it has to move quickly. If government cannot afford to subsidize a huge, overbuilt state sector, it has to act rapidly; otherwise the country will go off into hyperinflation. But economists also now recognize that the size and nature of sectors repressed under the previous economic system make a huge difference. China, for example, could achieve a great deal of growth and productivity increase once it liberalized its large repressed sectors, such as agriculture. This gave them space for gradual reforms in other areas. In general, economists should avoid being dogmatic and saying that one type of policy is always the best for all countries. We have to look at each country and judge the policies on their merits.[11]

- ***Fiscal constraint on reform***. Many analysts have emphasized the need for tight and active fiscal policies, to support stabilization and enterprise restructuring; they have also underlined the importance of quickly reforming the tax system. At the same time, fiscal deficits are expected to increase. The "transitional recession" and lags associated with the development of a new tax system are expected to result in a fall in revenues in the short run. And social expenditures are expected to increase as they are transferred from enterprises to budget.
- ***Choice of nominal anchors in stabilization programs***. Substantial debate surrounds the choice of nominal anchors in stabilization programs.[12] The main choice has been between a money anchor and an exchange rate anchor, both often used in combination with restrictions on public sector wages; and the debate has been primarily over whether greater reliance should have been placed on the exchange rate anchor. The uncertainty of changes in money demand, the adequacy of foreign reserves and the role of the chosen anchor in signaling and establishing credibility are seen as choice factors. At the same time, it should be recognized that both money and exchange rate anchors have proven to be effective in a variety of stabilization programs in transition countries. This is consistent with the evidence here suggesting that the most critical factor for the success of

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[11] Although some scholars strongly argued that privatization speed has a negative effect on growth. Godoy Sergio, Stiglitz Joseph E. (2006), Growth, Initial Conditions, Law and Speed of Privatization in Transition Countries: 11 Years Later, NBER Working Paper 11992

[12] Домбровски Марек (1998), Фискальные проблемы в период трансформации

stabilization in transition countries is likely to be the extent of economic liberalization, irrespective of nominal anchor choice. As discussed widely in the literature, what is critical for the success of stabilization programs is their credibility, and in the context of transition, credibility does not come without extensive liberalization.

It is impossible to analyze banking and budgetary system without including the foreign sector as a contributor to the budgetary revenues and domestic and foreign debts as a major component of budgetary expenditures.

International Economic Integration

As indicated earlier, in Soviet times, both the organizational arrangements and foreign policies were fundamentally different from those typical of market economies. The results of these differences were often controversial and difficult to measure precisely, and they vary from country to country. But it is clear that to be successful each country has to integrate into the global economy.

Foreign trade systems have a variety of components, but three components are of special importance:

! Change in the organizational arrangements and related infrastructure. During the command era, the trade was conducted by and through state organizations, whereas in the market economy, trade will be conducted primarily through emerging private enterprises and organizations.

! As organizational arrangements change, so must the policy system. As with elements of transition, the development of appropriate policy framework is especially challenging as a state role is reduced in a setting of imperfect mechanisms for implementing new policies.

! The development of new financial arrangements was a major point of importance for integrating the transitional economies into world markets. During the communist era, barter arrangements in foreign trade dominated in trading arrangements due to absence of convertible currency. In many cases, the slow evolution of macroeconomy created special problems during the initial decade of transition - it was the close connection between an appropriate exchange rate regime, the domestic macroeconomy, and associated policies.

Safety net.

Throughout the Soviet era, there was a continuing attempt to change the social contract between the state and households, or an attempt to reduce the importance of purchased social services, which were instead provided as a part of social wage directly by the enterprise. This "benefits package" included child care, grade school and higher education, medical care, retirement benefits, and the like. It is clear that on one hand, the social contract must be changed and the package of benefits will shrink. On the other hand, the nature of the demands on the system will change as well. For instance, while retirement, medical and related requirements remain, a new set of demands – specifically unemployment and related benefits – will emerge. There are four basic aspects of the safety net:

o Needs must be identified. For example, requirements of the aging population must be established, along with required medical services. During the transition, much attention has focused on income, or, more specifically, on the changes in the level and composition of household income, income inequality, and the meaning and measurement of poverty.

- It is important to develop the infrastructure necessary to deliver services.

- New sources of funding must be established.

- The system must change from one of benefits that are available to all to one in which benefits are delivered to those in need. A means-testing system is one in which recipients of welfare benefits must demonstrate a need for these services, and this need is usually demonstrated by a lack of income.

Role of Governments

Transition economies emerged from socialism with the state playing a dominant role in the economy. Although broader issues of an appropriate role for the state in transition economies have sustained over time, it quickly became clear that the role of the state in the newly emerging market economies would be reduced and would be different.

The transition countries' experience shows that market-supporting institutions do not emerge quickly in response to demand. After allowing for differing initial conditions, it turns out that the fall in output in transition economies was associated mostly with poor business environment, resulting from institutional collapse. In most FSU countries, the collapse of the institutions is observable in the dramatic increase of the share of the shadow economy (30-60%); in the decline of government revenues as a proportion of GDP; in the inability of the state to deliver basic public goods and appropriate regulatory framework; in the accumulation of tax, trade, wage and bank arrears; in the demonetization, "dollarization" and "barterization" of the economy, in the decline of bank financing as a proportion of GDP; in poor enforcement of property rights, bankruptcies, contracts and law and order in general; in increased crime rates; etc. Liberalization alone, when it is not complemented with strong institutions, cannot ensure good performance. So, in transition periods, governments have the special mission, that is, institutional evolution.

Institutional evolution is required for the creation of the "rules of the game," understood in the broad sense of political economy, rather than merely the behaviors of agents within a given set of rules already in place. Most observers agreed that it would be desirable to establish quickly the rule of law to underpin a market economy before state enterprises were privatized. The adverse supply shock or Transitional Depression in this case came from the inability of the state to perform its traditional functions – to collect taxes and to constrain the shadow economy, to ensure property and contract rights and law and order in general. [13] Finally, performance was of course affected by economic policy. Given the weak institutional capacity of the state, i.e. its poor ability to enforce its own regulations, economic policies could hardly be "good". Weak state institutions usually imply import substitution and populist macroeconomic policies (subsidies to noncompetitive industries, budget deficits resulting in high indebtedness and/or inflation, overvalued exchange rates), which have devastating impact on output. On the other hand, strong institutional capacity does not lead automatically to responsible economic policies.

[13] It is not the first case when success or fail of reforms depended on governments. Gorbachev reforms of 1985-91 failed not because they were gradual, but due to the weakening of the state institutional capacity leading to the inability of the government to control the flow of events. Similarly, Yeltsin reforms in Russia, as well as economic reforms in most other FSU states, were so costly not because of the shock therapy, but due to the collapse of the institutions needed to enforce law and order and carry out manageable transition.

These five components of the transition process – Microeconomics, Macroeconomics, International Economic Integration, Safety Net of Transition, and Role of Governments - are essential elements of transition whether viewed from perspective of rapid change (Shock Therapy policy) or from the perspective of slower evolutionary change (Gradualism approach). There are several other elements (for instance, the development of an appropriate legal infrastructure) that we have not specifically identified or isolated, but consider them as complementary and they could be added.

5. Concluding remarks.

Many important questions concerning transition periods do not yet have definitive answers. The fact is that so much remains to be done in developing economic theory. First of all, it is necessary to separate different types of transition.

There are strong incentives and base for the development of Transitional Economics as a special part of Economic Theory. Although, the starting point, speed, and scope of free market reforms have varied greatly among transition economies because of existing diverse array of national initial conditions and political developments, the common features stay the same across the FSU countries.

The components of transitional process may be classified in the following dimensions that, in turn, constitute the structure of Transition Economics. These components are: Microeconomics of Transition, Macroeconomic of Transition, International Economic Integration, Safety Net of Transition, and Role of Government. These parts are closely intertwined, and taken together, they completely describe the transitional process in all transition economies.

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