

Transition and Afterwards: Peculiarities of State Economic Policy

Abstract

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I

Collapse and dissolution of the Soviet Union was not just the end of the last empire in modern times, but also the beginning of systemic changes in the countries of demised Soviet block. The centralized command economy and autocratic repressive political system and police state were to be replaced by market economy and system of democracy. The move towards economic and political freedom was a powerful force which led to fundamental changes in the whole societal life. During this process the third component of the same importance came to surface – a civic society which asked for, as its main precondition, social cohesion.

Subsequently the whole theory of economic and political transformation rested on three decisive issues – creation of free market economy, democratic political system and civic society.

Relation between economic growth, democracy and social cohesion (determined by degree of income inequality and provision of education and health services) has been widely discussed by economists, politologists and sociologists debating the issue of transition. The conclusions are mixed, which has, so far, implied some general finding that the relations and correlations between the three phenomena depends on many specific circumstances and factors.

Generally all three phenomena are bilaterally and multilaterally linked in one positive relation – progress of any one means the same move of the other two. However, this general rule is far from precise and exploratory when dealing with more concrete cases of transition. The reasons are quite obvious.

First, although unrestricted market forces seem to be best prepared to promote the highest growth rate (at least according to the liberal economic theory which is built on the presumption of full use of production factors and unrestricted price mechanism, which determines the most efficient uses of them), this is not the case, because economic growth needs rule of law (especially for securing property rights and

execution of contracts) and, therefore, asks for at least some degree of institutional (legal) stability (i.e. some adherence of the law by the government).

The emphasis on economic growth may well lead to deepening of social differentiation. Market forces always glorify and gratify efficient performers and severely punish losers.

Generally, economic growth creates basis for and makes positive impact towards reduction of income inequalities and strengthening democracy. On the other hand, it asks for political support which, in turn, requires some degree of solidarity in income distribution, i.e. some extent of social cohesion. „Our analysis highlighted the fact that, while economic reforms are needed to foster growth, they must be designed in such a way that they do not undermine political support for reform. Thus, policies reducing harmful social impacts of economic growth ... form a crucial element of a successful reform package, even from the efficiency point of view.“¹

Second, there is also no explicit link between democracy and economic growth. To put it more precisely, a link does exist, but, according to one study, , it „... is subtle, indirect, and contingent on levels of development.“²

Third, democracy positively correlates with social cohesion – both due to its inclination to use more intensively redistribution mechanism (and, on this basis, to obtain large public sector) and also to stronger public control in the use of the expanded public sector funds and other resources. And vice versa: „... higher standard of living promotes democracy.“³ But again: the correlation is indirect and not causal: „... the public sector development has both positive and negative effects on income inequality.“⁴ As Cheol-Sung Lee points out, the exact nature of such a link is mediated by the existence of institutionalized democracy, i.e. the institutionalization of public accountability and alternative political forces.⁵

¹ Bank of Finland. Institute for Economies in Transition BOFIT. Discussion Papers 2003, No. 4. Byung-Yeon Kim and Jukka Pirttilä. The political economy of reforms: Empirical evidence from post-communist transition in the 1990s. p.20.

² Baum, Matthew A., David A.Lake, The *Political Economy of Growth: Democracy and Human Capital*. *American Journal of Political Science*, Vol. 47, No. 21, April 2003, p. 333.

³ Barro, Robert J., Determinants of Democracy. *Journal of Political Economy*, Vol. 107, No. 6, 1999, p. 182.

⁴ Cheol-Sung Lee, Income Inequality, Democracy, and Public Sector Size. *American Sociological Review*, Vol. 70, February 2005, p. 175.

⁵ Ibidem.

Although some of these characteristics have been studied before the last transition took place, most of them entered the agenda of both scientific research as well as political practice only when the Soviet empire ceased to exist and the political and economic transformation begun. What looked as being of the second importance, now became the top issue of practical political agenda - the sequence of reforms, causal relations between reforms in different areas of public life, and circumstances determining the directions and intensity of the causality.

This explains why transition countries, while receiving much of external aid in their efforts for systemic changes did not receive anything about sequence, relative importance of different actions and independent factors determining or influencing success in the efforts. International financial institutions, sponsor countries were able to explain in details and assist in implementation, separately, free market economy institutions, democracy institutions, modern legal system – but they could not consult about the sequence and factors of reforms, since they neither ever did it themselves, nor there was theoretical knowledge about it.

Thereby investigation of the transition of the Soviet block countries to normal stance can increment our knowledge about how societal systems are being reformed and transformed. But it is not the only benefit. Transition studies are capable to deliver an input to the more general knowledge about the nature and role of state in modern societies.

II

State in transition countries was immediately charged with huge and, perhaps, paradoxical responsibilities. It had to conduct systemic changes which should lead to state's withdrawal from the economy and reduction its role in society's governance (together with changing the nature of state's role in new structures). The experience of Lithuania allows some generalizations about peculiarities concerning state's role in transformation of economic system which was crucial for the whole success.

First, the most difficult thing for state in the first phase of transition was to find right positioning in solving social problems. Deprived from monopolistic position in the whole economy state remained charged with social issues (education, health services, pensions, social care). It tried to mimic expanded social protection schemes from mature European countries, unable however to provide necessary financing for them. Schemes fuelled illusory expectations for social protection, and this served as an obstacle for creation a new system based on social and private insurance.

Second, state was forced to engage in activities which in mature societies belong to the competence of trade unions, NGOs and other civic movements and initiatives. In Lithuania it was state which took care on salaries, employment terms, collective agreements, negotiations between representatives of capital and labour. Quite frequently the Government acted directly as a representative of trade union of employees in private sector. The same may be said about the duty undertaken by state in assisting and stimulating small businesses and co-operatives among farmers.

Third, conspicuous feature at first stages of transition was unprofessionalism of actions. Although large technical assistance in different forms has been provided to Lithuanian public services, the positive results were not fast to appear. Economy and public administration were to built anew and this required time, training and learning.

These (and other) features allow to conclude the description of state's role in a transition country by two characteristics: first, at the first stages state in transition society is relatively more important than in any mature democratic society with market economy; second, the state itself (its institutions and officials) in such society suffer from significant shortage of professional capacities. These two characteristics explain why it was so important for Lithuania as for any other transition country to have most favourable (a) initial conditions, (b) institutions, and (c) economic (and other) competence. These three factors made final touches when transition country was undergoing systemic transformation.

III

The process of systemic transformation of the economy in Lithuania, a small country, was intertwined with the outside economic developments. Due to that the transformation may be described as a sequence of waves:

- 1) Free trade with western countries was the first common rush. For the command economies this was absolutely new occasion and experience. Reorientation of trade from CIS countries to countries of free market economy provided powerful force for the restructuring of the economy;
- 2) After trade growth started the inflow of foreign direct investment began. First as small joint ventures, established mainly for trade, then, with large scale privatisation, large foreign companies also establishing in Lithuania, and bringing many novelties to the local economy;
- 3) Still later, when privatisation and employment rationalisation led to significant unemployment, emigration took its place. First – mainly searching for illegal

employment, as from 2004 – legally employed (mostly to Ireland, UK and Spain);

- 4) With more than decade having passed and the transformation of the economy was completed, the credit expansion appeared. It came suddenly (starting from 2005), after the main banks have been privatised, accommodated and got ready to supply large amount of credits, using funds coming from their owners and other foreign banks as well. In the community where the use of bank credits was a rarity, now credit supply was swelling up by 50-60 per cent annually;

All these waves have been rendering powerful pushes to the national economy. Some of them stimulated trade, other – upgraded technologies, still other – helped families to find sources of income or better income. Their intensity created sometimes rather significant shifts in the economy and society, not necessarily positive, but with the final result always being modernisation and adaptation to new environment.

Almost in all cases state has been perceiving situation post factum; true, very often nobody could forecast the shifts. National community – because it did not wish (and expect) them, outside consultants and analysts – because the cases were not explored and described by theory. Still some waves may be projected in future. One of them, the nearest, should be the strengthening of “brain drain”, another one – growing immigration, up till now very restricted and unpopular, from more remote countries of Asia and Africa.

Crucial involvement into international exchange of goods, services, labour and capital creates for the government of small state quite unstable and unreliable niveau, and charges with quite significant burden of decision-taking. On the other hand, it comes together with the gradual maturing of the newly created national economic system. To learn this new role is exactly what the public institutions and the political elite in Lithuania has now on their agenda.