THE ROLE OF THE STATE IN EXTERNAL ECONOMIC RELATIONS

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During the process of transformation, not only is the pure economic sphere under fundamental change but so is the state.[1] This does not concern just the political system as such (i.e. the change from the monolithic one-party dictatorship to a multi-party democracy) but it inhibits also basic changes in the overall role of the state vis-à-vis the economy including external economic relations. In socialist days, the state was the sole owner of the means of production - with very few exceptions - and economic policy as well as practically all industrial enterprises were both concentrated in the hands of the bureaucratic centre which itself was supervised by the party. The state monopoly on foreign trade was the necessary supplement through which the needs of the domestic economy could be satisfied. Foreign trade in principle primarily served this objective which meant that managing external relations started with the definition of import requirements and only then tried to find out what domestic products might be suitable for export in order to pay for the needed imports. The role of the state in the new market economic framework has to change completely, but at the same time the state must design the whole process of transformation while being itself under reconstruction.

International Economic Problems

In today´s World the exchange of goods, services and capital takes place in a very complicated environment. Even before globalism became *the* issue, the intensity of interrelationships between national economies created problems by the simple differences which exist between various aspects and areas of economic life in the countries concerned:[2]

- money and banking;
- inter-regional and interstate wage differentials;
- differences in factor mobility;
- differences in price levels;
- differences in the availability and mobility of capital;
- different national policies on foreign exchange, subsidies, taxation;
- regional pride (buy British);
- differences between inter-regional and international trade;

- others, such as driving on the right or left, language, custom, usage, habit, taste, standards, measurements (inch or metre), etc.

Under socialist rule and the command plan economy, most of these differences and the problems they caused did not count since external economic relations were regarded only as a kind of unavoidable appendix to the national economy, required to fill gaps which domestic production was unable to do. The state did not feel it necessary to act economically when entering foreign markets or trading with other planned economies - it only had to balance the foreign exchange account and if this did not work then look for respective credits. The state, exerting its foreign trade monopoly, could neglect most of the above cited differences, but by doing so was not able to extract the potential gains from foreign trade. This became more and more obvious the more industrialised and diversified their economies became. In particular, trade with the market economies took ever larger shares in overall trade of the planned economies, whereas the "easier" goods exchange with other centrally planned economies gradually lost significance.

Creating and Securing the Framework

The situation changed completely with the breakdown of centrally planned systems and the start of the transition to market economics. The state had to create at the very beginning a legal framework for an economy in which the majority of enterprises were soon to be private. This included, *inter alia*, a new banking system, competition policy (anti-monopoly law), new fiscal regulations, the setting-up of a capital market (stock exchange), and a new labour code. But, in particular, it also included regulations concerning the external economic relations for all economic subjects, the state included.

Without going too much into detail, in a market economy the state must guarantee that economic exchange with foreign subjects (i.e. exchange of commodities, services and capital) can be accomplished without major restrictions by tariffs or non-tariff barriers such as import quotas, export lists, monopolies or norms, and financial (currency) regulations. However, this principle cannot be kept absolutely and always because standards (e.g. sanitary or environmental) can vary substantially from country to country. Nevertheless, practically all transformation countries started from the very beginning with fundamental liberalisations of their external economic relations whilst also seeking to liberalise their financial systems as rapidly as possible.

When setting this liberalised framework, the state can and normally will set restrictions in its laws on external economic relations in the following cases when there is need:

- to enable the fulfilment of obligations deriving from international agreements;
- to prevent or counteract against effects from other countries that limit, adulterate or impede competition on the domestic market or which might lead to the confinement of economic relations with third parties;

- to ward off damaging inflows of money and/or capital from foreign countries which might jeopardize macro-economic equilibrium;
- to guarantee the security of the country (this relates primarily to the arms trade and the export of knowledge).

Accompanying this general framework, the state has to provide for a monetary and foreign exchange system that makes liberalised market signals regarding the flow of goods, services and capital possible.

Basic Tasks of the State in the Context of External Economic Relations

Even in a market economy with the basic principle of the liberalised flow of goods, services and capital, the state has specific obligations which are partly derived from the above listed needs to intervene, but which are also (partly) fundamental truisms related to the differences quoted above.

First of all, the state concludes international bilateral and multilateral treaties. These include all kind of special agreements on many issues such as cross-border exchanges and the formation of bi- or multi-lateral free trade zones and/or customs unions. But in particular, it is the duty of the modern (market economy) state to incorporate its economy into the international trade policy systems of the WTO, OECD, and other international financial institutions such as the IMF, IFC and World Bank.

At the same time, the state must ensure that its own economic actors can enter international markets and withstand international competition without difficulties that might derive from inappropriate state commercial, monetary, exchange rate or other policies. Better still, the state must accomplish policies that support the adaptation and integrational process of the economy into the international division of labour. This even comprises such fields as domestic budgetary behaviour (public deficit) or inflation policies, but in particular it calls for a careful and cautious balance of payments surveillance in order to avoid excessive foreign indebtedness with related effects on exchange rates, credit worthiness and the like. It goes without saying that the independence of the central bank with regard to monetary policy must be seen as a precondition for a functioning market economic system.

In this context it must be mentioned that one of the most important duties of the state is to secure the functioning of financial and capital markets. For international investors, it is crucial that a state is willing to guarantee the safety of foreign investments by law and maybe through additional bilateral and multilateral agreements. The state is also requested to introduce a tariff policy which provides the necessary protection for national suppliers on domestic markets, but which also complies with international standards and multinational agreements. In this context, the state will need to take care of infant industries and of regional disparities. Furthermore, a state can also pursue an industrial policy in the sense that it tries to foster economic development in distinct branches of the economy in order to become competitive on international markets or at least to reduce dependency. Since many if not all countries pursue some kind of export credit support policy, be it in the form of state insurance or special interest subsidies, the countries in transformation must offer their export industries similar support schemes.

Specifics Regarding the Role of the "State in Transition" in External Economic Affairs

The basic features of the role of the state in external economic relations as presented above are also relevant for the economies in transition of the CIS and Eastern Europe. However, beside these generally valid considerations, some peculiarities can be identified which can either underline or even enforce these arguments, or which derive from problems or developments that are akin only to these societies.

- ***The Effects of Unfinished Privatisation***

Although most countries in transition have for some time been able to boast shares of the private sector in GDP in excess of 50%, the remaining state-owned enterprises (especially larger firms which used to be particularly involved in foreign trade) must also perform in this new environment. So even without being privatised, state-owned firms should still behave like private firms. But of course conflict situations will arise when the state on the one side is requested to act as an impartial framework setter and protector of pure competition, but on the other side is indirectly a co-player on the market through those state-owned enterprises.

An extremely difficult relationship in this respect developed between the state in transition and the process of privatisation. A view widely shared is that state institutions should play a decisive role in privatisation, and it comes as no surprise that such a view can be found in governmental circles in particular. However, most economists agree that the state should primarily stand aside from the development of the private sector and ensure that its own agencies only remove bureaucratic obstacles. The slow progress achieved with privatisation so far in some countries of South-East Europe as well as in some CIS states affects the role of the state in these countries in transition. There are a number of implications and dilemmas arising from the privatisation process in itself.

The fundamental reorientation of the state's economic activities from subsidising and developing all economic activities towards functioning like a government in a market economy (i.e. developing an appropriate infrastructure, providing public goods, laying the foundations of an acceptable social policy, sketching a sound regional development policy) is in conflict with existing reality, in particular with the impact of privatisation on budget revenues. During the process of privatisation, old and reliable sources of revenue disappear whereas new flows of income are meager indeed.

In order to secure the necessary revenue, new tax regulations can very easily incorporate the risk of disincentives from high marginal tax rates. In these difficult days of hard competition on the world market, especially for newcomers, exporters should perhaps enjoy preferential treatment in the form of tax breaks. Furthermore, there is the question of how to cope with the widely applied use of tax evasion in the new private sector when the entire system of tax collection is still evolving.[3] In addition, maximising revenues has not received priority among the considerations of enterprises during the transformation.

Not only will government revenues deriving from the profits of state enterprises fall when these firms are privatised, but state expenditures may even increase in the short run on, for example, the administration of the privatisation process or the restructuring of enterprises prior to privatisation. Money will also be needed for unemployment payments and retraining programmes. The question is, how much of a balance can be achieved between these shortcomings on the one hand, and the reduction of subsidies from the state budget to still existing state firms on the other. These state enterprises might therefore lack the necessary investment and restructuring support needed to become more competitive on international markets.

As indicated before, the privatisation process in South-East Europe and in the CIS had a late start relative to Central Europe and is proceeding only slowly. In particular, the privatisation of large state enterprises that are export oriented provides enormous difficulties. Implications and dilemmas from this slow progress are manifold, but at least two should be discussed further:

Firstly, necessary structural reforms are advancing only at very low speed. As in earlier times, the state is asked to think about structural (industrial) policy, an activity from which it should be excluded as much as possible in the new framework of a market economy. But what are the alternatives? The countries concerned have already experienced heavy shortfalls in economic growth and are confronted with difficult and competitive conditions on the World market. In some countries such as Bulgaria and Romania, the still relatively small private sector can only provide marginal improvements so long as a majority of industrial enterprises remain state-owned. There is a desperate need for a structural/industrial policy, but who should give the directions when real conflicting economic interests cannot compete in the desired way because the state still owns the greater part of the production assets? Again, the decisions will be found within the administration, be somewhat arbitrary, and not necessarily the result of a proper dialogue between different economic agents and the state. This, accordingly, must also have an effect upon the external economic relations of the respective countries. At least one can observe clear differences in the performance of foreign trade between those countries where privatisation has advanced substantially over the past few years (e.g. Hungary, the Czech Republic, Estonia or Poland) and elsewhere where the state still plays a major role in the economy and thus also in foreign trade.

Furthermore, the state in these latter countries is confronted by the obvious fact that its enterprises as currently structured are not attractive enough to be purchased either by domestic or foreign investors. Distributing shares gratis to everybody does not provide new capital and nor does it create capitalist entrepreneurs. Should the state in this situation start with restructuring those enterprises which are considered to be potentially competitive? But who should select and determine, and according to what principles, which ones are potentially competitive? From where should the necessary finance for restructuring come? Thus, the slow progress of privatisation only prolongs the time the state needs to subsidise enterprises without being able to restructure them, which again extends the time until investors might find them attractive enough for acquisition.

It is obvious that the state in the former socialist countries of South-East Europe and the CIS must perform many roles in the course of transforming the political as well as the economic system. The state is supposed to privatise as much as possible of former state-owned properties, but since this process proceeds very slowly, it also remains the largest owner of production assets for some time. This means that all the responsibilities for the greater part of these firms and in particular for their employees still lie in the hands of the state, represented by elected politicians. How can they decide about closures or cuts in employment when they are constantly confronted with the argument that under socialist rule full employment was guaranteed? The pressure for implementing industrial policy to subsidise further the still large state sector is extremely strong in all these countries. As a result, privatisation has been half-hearted and soft constraints on state enterprises have been allowed for social reasons. In turn, such policies have boosted budget deficits which make economic stabilisation more difficult to achieve. In these countries, the state in its role as the largest entrepreneur will still have to decide for some time on many micro- and macro-economic issues, investment preferences in particular, although at least all micro-economic (entrepreneurial) decisions should be transferred completely to the non-state, private sector. However, since the latter still remains far too small to play a decisive role in the larger industrial sectors, the state has no other choice!

The state is asked to pursue a policy of economic growth and of social welfare, but most of the institutional prerequisites are not yet adequately developed, nor do the new democracies have enough experienced politicians and bureaucrats. For example, in some countries the position of the central (national) banks within the new multilevel banking systems is still not sufficiently independent of the government to enforce a stabilisation-oriented monetary policy. In the case of Croatia where the Central Bank governor tried to do this, the government successfully blocked his move and restored governmental supervision over

Central Bank policy. Another example is Bulgaria where the parliament was until recently able to force the National Bank to finance the state budget if deficits were pending. These examples serve to prove how difficult it is to establish a clear division of power between the legislature, the executive and the judiciary, as well as between government and independent institutions like the Central Bank.

In principle, it seems to be clear to all parties concerned that the state, represented by political as well as by administrative bodies, should try to implement and perform a clearly market-oriented policy with as little interference as possible. It should act as if there existed already an economic system where private ownership of the means of production dominates and where the state exercises only the role of a night-watchman (i.e. indirect control). But it also seems that many politicians, once they have seized power, are quite willing to forget these objectives. To be re-elected is a very understandable short-run objective and many of the measures which should be applied for the sake of the long-run target of establishing a proper market economy are at present not well liked by the electorate. Furthermore, unfinished privatisation has given unscrupulous politicians the chance to make personal profits from the remaining foreign trade monopolies of the state - the Bulgarian example of the grain export scandal in 1996 is a striking example.

Given the situation that for quite some time the state will remain the owner of a greater part of the production assets, then in principle the major question remains as to how the state can separate itself from the transitionally necessary role of controlling and more or less managing the economy. This can happen by either carefully delegating entrepreneurial decision-making to independent agencies which administrate state property, or by granting total entrepreneurial autonomy to individual state firms. However, in the latter case, the state still carries the final economic and social responsibility of the owner and has at the same time to delegate full managerial authority to persons who most frequently belonged to the former socialist management nomenclatura. In any case, a market economic environment with a demonopolised and competitive structure must first be created in order to force agencies and/or managers to behave and perform like private, profit-oriented bosses. However, the major problem remains that most of the enterprises run at a loss and the state will once again be asked to subsidise them because no alternative source of financial support is forthcoming. Denying this support would be the same as deciding to liquidate the enterprise, whereas granting the subsidy is more or less a continuation of the former system of central, administrative economic control. Maybe a way between the two would be to set a very clear programme of declining subsidy which would force the enterprise managers to reckon with a constantly decreasing cushion over a limited period of time.

Secondly, and probably the more important and demanding task for the state, remains the further advancement of the overall transformation process, parallel to its function as a care-taker of the state's entrepreneurial heritage. The longer progress with privatisation is delayed, the more difficult it will be for the reform politicians governing the new democracies to proceed with the necessary institutional and process-oriented reforms. This is because pressure from the non-private sector re-emerges and receives growing support from the population which becomes increasingly concerned about its socio-economic well-being. "Good old socialist times" with full employment and no (officially admitted) inflation will be nostalgically remembered the longer the present depressing situation continues.

Facing this mixture of tasks and dilemmas one must also bear in mind that, within the new political class, no experience exists either with regard to "normal" market economic policy or with the flexible management of a mixed economy. Political parties have no experience in formulating electoral platforms where economic and social issues might be addressed in a way that explains to the citizens the difficulties and the necessities of a complete transformation policy. In addition, no political culture of compromise or coalition exists. Political parties would rather seek confrontation and rely mainly on negative critique rather than seeking constructive balance. Therefore, people have become distanced from the state, its representatives, and from politics in general, especially reform politics. This only encourages politicians to become even more cautious and reluctant concerning radical and - in the short run - painful measures which in turn leads to a prolongation of the difficult time of transformation and adaptation. Under such conditions, new democratic governments find it more difficult to justify their existence.

- ***National Interests and External Economic Relations***

One of the primary effects of the big change in 1989/90 was the complete collapse of the former so-called socialist World market represented mainly by the CMEA and its respective commercial ties among partner countries. The newly elected national governments did not try to re-establish former "unrealistic" commercial connections and cooperation but re-oriented their external economic relations almost exclusively towards Western industrialised countries. This was mainly caused by political motives, since first of all these countries wanted to remain completely independent from their former hegemon, the Soviet Union, later the Russian Federation, which had been for all of them until then their biggest trading partner. Because in the first years of transition the state still played a decisive role in economic life, this foreign relations reorientation (to the West) could been carried out quite easily.

One finds that in many of the transformation countries, the state tried and still tries to hold control over some so-called "sensitive" sectors by not privatising the usually monopolistic enterprises therein. These sectors mainly include armaments production, energy and transportation. Regarding armaments production, the state acts quite often as client, supervisor, producer, and banker. Defence is regarded as public good, and so far one is not yet used to thinking in terms of competitive markets. A complete reorientation is therefore still to come.

Of course, as long as the state is still a major player in the economy because it owns important, large and often strategic enterprises, the temptation to use this power over foreign trade for external political purposes is considerable. Russia does this vis-à-vis Belarus and Moldova, and attempts to with the Baltic states. Bulgaria is dependent upon Russia for its purchases of raw materials, in particular of primary energy. Thus, only recently, *Gazprom* has managed to purchase all the shares of the main Bulgarian gas distributor, *Topenergy*.

- ***Intra-Regional Cooperation***

One negative outcome of the collapse of the CMEA was that intra-regional cooperation did not emerge to compensate. On the contrary, official foreign policy in the smaller East-European countries clearly rejected any such attempt or even proposal (as from the EU) as an unwanted return to backwardness and dependency. All the reasonable arguments for intensified cross-border cooperation and larger regional initiatives were turned down due to fears that this might be understood as a substitute for European integration. Here again, governments are asked to perform because they are the actors in such fields of cooperation as infrastructure, transportation links, and environmental protection. The state is the initiating and framework setting partner whilst enterprises can profit from any opening of cooperation opportunity. However, so far not much has happened in the regional agreements that do exist such as the Central European Initiative (CEI) or Black Sea Economic Cooperation. Only CEFTA succeeded to a limited extent because advantages from tax reductions and other restriction removal have been so obvious that political arguments against closer cooperation became obsolete. Nevertheless, even here no guarantee for sustained maintenance of what has already been achieved can be found. As soon as problems with the balances of payments in the Czech and Slovak Republics appeared, a rapid return to former protectionist habits occured. The state did not have enough courage and self-confidence to look for other, less restrictive means than import quotas and import surcharges.

This points at a crucial issue. Understandably, the new democracies lack experience and self-confidence in many respects. Especially in the field of external economic relations, many of the existing officials in the ministries of trade have previously been employees of the former foreign trade monopoly and are not experienced in market economics. In addition, in these countries the necessary interplay between monetary, fiscal and exchange rate policy on one hand and industrial policy and foreign trade policy on the other are still underdeveloped.

- ***The State and Foreign Capital***

All countries in transition are in desperate need of fresh capital for their restructuring and modernisation efforts. The inflow of capital either in the form of share purchases, joint ventures, green field investments or portfolio investments is something which is to a large extent dependent upon overall expectations of future economic development. But investors are even more sensitive to government legislation and/or intervention. An investor does not only look at short term profits but also takes into account many other factors such as monetary policy, exchange rate policy, taxation, the ability to purchase assets such as land, interest rates, import and export restrictions, and the ability to repatriate or reinvest hard currency profits. All of these factors are under the direct competence of the state and can be of utmost importance if differences to other competing countries exist. This can be observed in the transition countries where some only liberalised their economic legislation after having seen countries such as Hungary or the Czech Republic steal a march. The often heard argument that one should not "sell out the domestic economy" is to a large extent economic nonsense. In Germany, one quarter of all industrial shares traded at the various stock exchanges are owned by foreigners and no one is afraid of alienation. In the Netherlands or Belgium this ratio might even be higher. Therefore, the state does have a duty to initiate or at least support transnational cooperation in an increasingly globalising world.

The State and the Marketing of Foreign Trade

Overall competition in global markets has became extremely tough. In practically all Western market economies administrations try to support non-governmental trade promotion. Some pursue even more active and direct foreign trade promotion both by providing information about foreign markets and the special conditions and requirements therein, and through financial and logistic support for special promotion events abroad. Direct contacts are established between ministries and non-governmental institutions which lobby both the EU and WTO, and in other countries in favour of respective domestic exporters. In addition, special foreign trade credit lines provided by state related banks (US *EXIM-Bank*) and credit insurances through quasi- public institutions (German *Hermes*) are common instruments which allow such public-private-partnerships to flourish.

Conclusions

The general rule is that the state should restrict itself to the supply of basic public goods (the legal system, defense, health procurement, education, etc.), and should take initiative in those cases where the market fails due to external effects, natural monopolies or asymmetric information. However, in the last

World Development Report of the EBRD and the World Bank it is stressed that there are no universally applicable recipes either for the extent or for the kind of state activities with respect to the economy. In principle, this depends firstly on the question of whether industrial policy is requested or even needed for the respective economy, and, secondly, whether the existing political and administrative capabilities are sufficient. This defines whether an institution-light approach is applied which understands only general, simple legal regulations that are incorporated into transactional-specific contracts, or whether an institution-intensive approach is chosen with special regulatory bodies (agencies) which dispose of far-reaching competencies within the framework of their legally defined duties.

For the transformation countries which have inherited an enormous amount of unproductive capital stock under state ownership and control, concepts are required for formulating a theory of - and the respective political decisions for - a new flexible role of the state in transition. This control can also be felt in the shaping of external economic relations where not only economic considerations form the basis for trade politics, but also "old thinking". Prospects for the ending of this power are not good. On the contrary, the danger exists that in countries lagging behind in the long and difficult process of establishing a market economy, the employment of non-market procedures may be reinforced. As argued before, a new push for privatisation is therefore needed in order to pave the ground for a rapid dismantling of the still too dominant role of the state.

Notes

1. In this paper, the term "state" is used to convey both the entirety of the institutions of a state and government policy.
2. For further detail, see Ch. P. Kindleberger. *International Economics, 3rd. edition*, 1963, pp.4-16.
3. For a deeper discussion of the fiscal aspects of privatisation, see M. Bornstein, Privatisation in Eastern Europe, "*Communist Economies and Economic Transformation*", Vol 4, No.3, 1992, p.303.