

# The Characteristics of Transformation of Institutional Changes and Georgia

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**Abstract**—The analysis of transformation of institutional changes outlines two important characteristics. These are: the speed of the changes and their sequence. Successful transformation must be carried out in three different stages; On the first stage, macroeconomic stabilization must be achieved with the help of fiscal and monetary tools. Two-tier banking system should be established and the active functions of central bank should be replaced by the passive ones (reserve requirements and refinancing rate), together with the involvement growth of private sector. Fiscal policy by itself here means the creation of tax system which must replace previously existing direct state revenues; the share of subsidies in the state expenses must be reduced also. The second stage begins after reaching the macroeconomic stabilization at a time of change of formal institutes which must stimulate the private business. Corporate legislation creates a competitive environment at the market and the privatization of state companies takes place. Bankruptcy and contract law is created. The third stage is the most extended one, which means the formation of all state structures that is necessary for the further proper functioning of a market economy. These three stages about the cycle period of political and social transformation and the hierarchy of changes can also be grouped by the different methodology: on the first and the most short-term stage the transfer of power takes place. On the second stage institutions corresponding to new goal are created. The last phase of transformation is extended in time and it includes the infrastructural, socio-cultural and socio-structural changes. The main goal of this research is to explore and identify the features of such kind of models.

**Keywords**—Competitive, environment, fiscal policy, macro-economic stabilization.

## I. INTRODUCTION

THE once again confirms that the set of traditional instruments of economic reforms such as: liberalization, stabilization and privatization represent the required but not enough condition for achieving economic growth.

We think that the low rates of economic reforms in these countries and in particular in Georgia should be found in wrong understanding of those forces which give the opportunity to production factors effectively interact during creating the national product. These forces represent the stimulation system and they influence the transaction costs level, the opportunities of specialization and cooperation and in all, they influence the behavior of economic agents. Typical to this or that economic system stimulation system is formed by the influence of formal and informal institutes and it has an impact on the enforcement of protecting property rights and contractual relations, on the access to capital and other financial resources, on the level of

market infrastructure, on the efficiency of the state's bureaucratic, administrative and legal system, on the free entering and exiting the market. These factors represent business environment through the borders of which are formed the market deals and the environment that has an impact on the effective functioning of firms.

Exactly market environment defines the effectiveness of investments, labor producers and the overall entrepreneur activities during the transition process from centrally planned system to a market economy [1], [10]. In this paper, we will try to identify the factors that affect the effectiveness of firm's activities in transitional economies. Success of the transitional reform largely depends on how effectively new forming economy can cope with the informational problems, which include the problem of corporate management and contractual relations.

In the developed market economy, informal institutes (social norms), as well as formal institutes (laws, legal norms, executive bodies and etc.) play a significant role in solving this problem. Effective Institutes attach sufficient transparency to corporate governance, and as a result, old-heads lose their informational advantage to external owners [8]. Institutes ensure market's effective functioning at the expense of reducing transactional costs resulting from the informational asymmetry. This in turn leads to the stimulation of investment, encouraging economic agents for innovations, and as a result increases their action productivity. Unfortunately, it can be noted, that in Georgia on the side of competitive pricing mechanism there didn't operate the institutes which would fix the rules of economic agents' behavior and would supervise their implementation during the period of economic reforms [6].

All this has created favorable conditions for economic agents' opportunistic behavior, which in turn has helped increasing transactional costs on market. In other words, the environment arisen from such kind of incomplete transition has contributed the rent seeking oriented activity instead of encouraging entrepreneurial activity of economic agents, this means influencing government policy, changing legislative acts, changing norms and principles of regulation in order to create favorable conditions for own business. This practice which is called "State's Capture" which provides getting benefit for particular formation in the form of subsidies or tax breaks, as well as releasing from payment of used resources and putting restrictions on the access of other firms in the field, has an impact on the effectiveness of functioning market

mechanism as well as on the competitiveness of country's economy as a whole [7]. In such conditions entrepreneurs are addressing their own limited resources to bribing officials in order to create essential conditions for existence of non-competitive business, but not to conducting the restructuring. As a result of such actions, enterprises are put in unequal conditions. Competitive enterprises as well in the same situation have to spend large amounts of money on "rent seeking" and respectively, pay less attention to the improvement of manufacturing processes.

However, situation in this field has changed in a positive direction over time; at the present stage, the main problem in Georgian Economy stays the same: first, existing adequate market institutes which provide creation of legal and regulatory environment favorable for business development.

Secondly, it is difficult to access fund which is a required condition for business growth and development. None of the normally functioning company can implement large innovative projects at the expense of only their own funds. Fast growing and successful firms need more intensive injection of capital. Such sources, other than incomes from the sales, represent bank credits and sources received from sold shares and bonds. In other words, the availability of capital and business development as a result is directly depended on how effectively banking sector and financial markets are functioning.

The effectiveness of these institutes is defined with following factors:

- With efficiency of mobilization of accumulation in order to finance economic activities;
- With a low rate of system risk and with the existence of competition in financial market which provides a slight separation of rates on deposits and loans;
- With an easy access to leasing financing when purchasing equipment;
- With using a heading credit and its' existence;
- With a free selling of firm's capital;
- With the access to the information about borrower's reliability.

## II. METHODOLOGY

If we want to separate the impact of institutional factors on the economic growth during transition, we have to pay attention to the fact that nowadays practically no sign of normally functioning financial system can be seen in Georgia.

Access to the capital is very limited in particular when it comes to the lending of long-run projects. Infact, banking system doesn't play a role of function of financial intermediary which is exactly its competence. The level of accumulation and credits is significantly low. The reason of this can be following factors:

- High level of systemic risks;
- Very high disunity on the interest rates, between deposits and credits (due to low competition);
- Ignorance of market systems by firms in order to avoid payment of taxes;

- The lack of right information about borrower's creditworthiness;
- Incomplete legal regulation system.

The non-existence of securities markets and at the same time, weakly developed banking system lays serious obstacles to the development of business.

Thirdly, this is the contribution of developing infrastructure in business development. After the collapse of the Soviet economy Georgia didn't have enough funds to maintain infrastructure which was created still during "Soviet" period and funding of which came from common-union sources. Energy crisis, poor condition of telecommunications, unprotected borders of country and herewith, blocking of country's main connecting roads to overseas became a reason of excessive stretching of production cycles which had a negative effect on the efficiency of domestic business.

As the conducted analysis showed, the course of reforms in Georgia which was partially adequate to the conditions of developed market economy didn't prove to be effective to transitional economy. In carrying out transformations it was a big mistake to ignore the fact that countries obviously differ by their histories, by established social norms and cultural traditions, by available human and capital resource stocks, etc. In other words, economic reform is undergoing not in vacuum but in the context of specific society with the combination of political institutes and processes which are determined by the political forces existing in this society. As a result, implementation of reforms in a real life turned much more difficult and unpredictable than it seemed at the initial stage of reforms. This situation brought us to different results compared to it was initially expected.

As we know, gaining economic growth is of a primary importance according to the formulated goals by McConnell and Brue.

## III. CONCLUSION

According to Section II, we can conclude that the state should provide the terms of comprehensive restructuring in order to achieve right stimulating policy and sustainable economic growth which may be considered as one of the ways to eliminate necro-enterprises. Based on the analysis we can group factors which impede the progress process of reforms in Georgia.

1. This is the institution of private property which provides better utilization of production capacities compared to the state property.
2. The success of transformational reform in Georgia is largely depended on how effectively newly forming economy can handle informational problems and how it can handle the problem enforcement of corporate governance and contract relations.
3. This is the role of developing infrastructure in business development.
4. We think that the success of entrepreneurship in Georgia (which is one of the ways of necro-enterprises limitation) is largely depended on the classification of entrepreneurs

and on the skills, that are necessary for market economy functioning and forming of which was impossible during the period of administrative-imperative economy.

Thus, we can formulate that the low competitiveness of small and middle enterprises is a serious problem on the path of the country's economic growth and it ensures the long-run functioning of necro-enterprises.

The diversity of institutes in the transformation raises the need to examine change of old institutes with new ones. Theory of Evolution favors dependence on the predecessor 's development trajectory to solve this issue. It refers to the gradual change in the past socio-cultural institutions from the complex of institutions which creates this system. The government should affect on institutional environment in economy to strengthen such institutions which are the most optimal for the interest of the society.

Success in the period of transformation significantly depends on the Government's ability to create strong economic institutions which are crucial for existence of market economy and ensure healthy investment and business environment. Theory of Evolution has significant role to solve this process smoothly and positively.

During the transformation level of Gross Domestic Product (GDP) has decreased significantly however according the statistics living standard was much less affected than expected this fact indicated existence of the informal economy. Andrey Shleifer in his book confirms the same and notes that in the beginning of 90s the level of production decreased by 39% however the standard of living was improved from some point of view instead of deterioration [9].

Significance of informal sector is well described in the book by Hernando De Soto the Other Path. De Soto was managing the research on the phenomena of informal sector. Based on the research De Soto revealed that informal economy was functioning absolutely loosely and actually constituted the "heart" of Peru's economy. The income of informal economy was measured. The data revealed that informal economy constitutes significant part of Peru's national income this thesis was a basis of De Soto's theory about peoples' attempt to gain economic rights informally.

De Soto suggests laws of formal system should be based on the promotion of economic activities and they should be reflection of informal system [9]. De Soto provides quite convincing suggestions in his book and puts question marks on government's regulatory reforms. This research confirms noneffectiveness of governmental administrative-legislative reforms for promotion of economy. This fact was confirmed by the vague picture of Peru's economic data. De Soto suggests that the solution is other path which is provided by the informal sector and promotes dynamic changes and reforms which ensures effective integration of informal sector and government regulation [5].

Reforms implemented by De Soto and Institute of Freedom and Democracy facilitated thousands of firms to switch from informal to forma economy. From our point of view this is quite different and valuable approach in the reform process of institutions.

System of institutions consist of various supplementary and complementary institutes. In practices, there are cases when the analogues are drawn between economic institutions which participate in the allocation of recourses and property forms [5]. Generally, institutes create complementary systems. Substitution of one institution with another may collapse of system consistency. Such kind of substitution is especially dangerous when there is a strong relationship between the institutions.

Discussions between Evans, Acemoglu and many other researcher is related to the "evolutionary" institutions. "Evolutionary" type of institutions facilitate development, for instance through creation of public good such are education, infrastructure and attract investments. Discussed difference between evolutionary institutions is significant classification developed by economists.

The main empirical challenge is to understand comparative significance of different institutions: social capital, social norms and values; legislation and enforcement of law; political regime and the level of federalism, etc. Ideally, effect of different institutions can be measured separately or by merging several subsystems. However, it is not simple. First of all, there is a high correlation between these institutions. This is not huge problem because factors analyze enables to analyze correlated variables. We can say that factors analyze is a good mean for empirical analyze of institutions because identification of institutional variables are useful for further development of institutional system.

Part of the institutions change gradually, slowly and constantly [5]. When others change quickly intermittently and rapidly. Rapidly moving institutions may change in one day in case of revolutions. In contrast, social norms are the face of slowly moving institutions despite the fact that some of the social norm from the history point of view may change rapidly. Unlike the these legal norms belong to the rapidly moving institutions.

We all agree that role of the technology development is crucial for economic growth. Also, we should know the impact of the culture on economic and social environment [4]. Accordingly, we should pay attention to the past development as well.

Contemporary economists define economic growth as combination of technologies and institutions. The variability of institutions itself result from interaction of slowly-moving (Culture, habits) and rapidly moving (legal and political institutions) institutions. And this interaction between institutional change and technology promote economic growth [3].

#### IV. FUTURE DIRECTIVES

In order to analyze development level of Georgian institutions, their pros and cons we should analyze Worldwide Governance Indicators (WGI).

The following indicators should be analyzed:

- Voice and Accountability (VA) – Voice and accountability captures perceptions of the extent to which a country's

citizens are able to participate in selecting their government, as well as freedom of expression, freedom of association, and a free media.

- Political Stability and Absence of Violence (PV) -Political Stability and Absence of Violence/Terrorism measures perceptions of the likelihood of political instability and/or politically motivated.
- Government Effectiveness (GE) - Government effectiveness captures perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies.
- Rule of Law (RL) - Rule of law captures perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence.

The data sources are rescaled and combined to create the six aggregate indicators using a statistical methodology known as an unobserved components model [2]:

1. At the beginning data are standardized according the comparable components;
2. Governing aggregated indicator is obtained as a weighted average of key indicators;
3. Standard error is defined;

First of all, data s gathered. The source of information for WGI are: report of European Bank of Reconstruction and Development, report of Asian Development Bank, report of World Economic Forum, report of African Development Bank, etc.

Gathered information is united according the World Governing Indicator. Unobserved Components Model (UCM) is used: each source of information gives deep analyze related to the governance. Analyze of the complex data is difficult, however UCM solves this problem. WGI may not be the only indicator which defines the difference between the countries. However, it gives opportunity to obtain significant statistical information about the different countries.

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