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Shock Therapy versus Gradualism: The Central Eastern Europe (CEE) and East Asia Compared-A Review of Literature

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Abstract

This paper reviews a numbers of policy measures taken by the governments in different countries from CEE to East Asia. The findings suggest that despite a number of discrepancies in the economic transition path and policies to support private sector development and SMEs from country to country, there are two distinct models: The Central and Eastern European "shock therapy" approach and the East Asian "gradualism" approach. The findings also highlight that regardless of the political and cultural context, in the early stage of economic transition process where institutional support and market conditions are not apparent, the state and public sectors play key roles. Despite of different levels of interventions, governments from those countries have taken some institutional measures in encouraging the development of private sector and capital formation, and enabling political flexibility and economic structural flexibility for the development of economic transition from centrally planned to market oriented economy. It is important to emphasize that no matter how those inventions are, but how the state can support economic transition and private sector development through political shifts and economic interventions. It could be concluded that the state has significant importance in encouraging capital formation and capitalist industrialization in CEE and East Asian countries

Keywords: SMEs, Economic transition, Private sector development, The State

1. Introduction

SMEs cannot be dependent on their own inadequate resources and capability for their survival and development. SMEs must have cooperation or links with other large firms for efficient utilization of resources, removing access barriers to the market and making the best use of policies and incentive programs from the government. SME growth depends on many factors that vary from country to country. McIntyre (2002) therefore argues that a synergistic relationship between the SMEs and the larger enterprise sector is a critical factor. Havie (2002) observes that in China the development of the Township and Village Enterprises (TVEs) is an important factor for the growth of SMEs. In the initial review of sustainability of small and medium forestry enterprises in China, Sun and Chen (2003) identify the need for cooperation and links between numerous SMEs in varied locations that lack formal associations or networks. Thus, in a collective culture like China and Vietnam, when a formal network is not apparent, an informal network provides a relationship framework for SMEs to overcome resource constraints. McIntyre (2002) also argues that a synergistic relationship, based on both horizontal and vertical linkages, such as industrial district and cluster (cited in Julien 1993, and You 1995), and the external economies of agglomeration and scope, played a large role in the post-World War II successes of Northern Italy.

McIntyre (2001) also proposes the economic landscape of the relationship among large, medium, and small enterprises, regardless of several scholars' preference for thinking of SMEs as an alternative to the former SOEs. He has cited the example of Poland's policies, which abandoned 'shock therapy' and concentrated on commercialization rather than privatization of SOEs, while in Russia a comprehensively corrupt large enterprise privatization process, had entirely destructive economic effects. This means that small firms still need the support from large firms as their sub-contractors. The privatization and separation of large firms into small firms by policy inaccuracy has created a destructive effect on the Russian economy in the initial period of economic transition. According to Dallago (2003), SMEs in Russia have faced many difficulties due to policy mistakes and remained separate from large firms, whereas in Hungary policy stability has provided SMEs with sufficient co-operation with other firms and clear division of labor among governments at different levels. Hence, Dallago (2003) offers a new strategy: (a) the modernization and competitiveness of individual SMEs (e.g., by stimulating and easing investment activity); b) SMEs' vertical integration with both domestic and foreign companies; and c) horizontal integration among domestic and foreign firm SMEs. Regnier (1994) examines the experience of the four Asian newly industrialized countries (Singapore, Korea, Hong Kong, and Taiwan) and discusses how these countries have encouraged SMEs and created linkages between large and the small-scale enterprises. Empirical evidences in some developing Asian countries also supports this trend: large firms (particularly state enterprises) sponsored and promoted local SMEs in Indonesia (Hill, 2002); and the Department of Industrial Promotion (DIP) in Thailand implemented programs for the promotion of linkages between SMEs and large firms, and developing SME clustering and networking (Brimble, Oldfield and Monsakul, 2002).

2. Transitional economy and market reform

Transition means the process of change from a centrally planned economy towards a market economy, a progression that involves massive change at every level of society (OECD, April 1999). The transition from a centrally planned to a market economy was considered as an effective means of solving social and economic problems in these former socialist countries. A country that wishes to change its economy to a market-oriented one needs to restructure many things such as market liberalization, privatization, institutional development, structural adjustment, economic policy program of stabilization, deregulation and integration with the global economy.

According to Marangos (2003) and Dehejia (2003) there are two common approaches used for economic reform: 'shock therapy' and 'gradualism'. The rapid change initiative encountered by CEE countries can be defined as 'shock therapy' and the incremental change process undertaken by many Asian transitional economies is called 'gradualism'.

2.1 The Central and East European approach

The CEE transitional countries applied the rapid change 'shock therapy' to put the economy on 'automatic-pilot' and let the markets decide supply, demand, and prices and economic transformation. The government sectors play an insignificant part in this economic system. According to Katz (1995), the approach remains controversial after five years of transformation. Economic transition in the former Soviet Union could be a case in point where inflation and unemployment remain problems. In supporting the 'shock therapy' approach, Marangos (2003) analyses the disadvantages of gradualism that have resulted in many problems such as ill-defined property rights, badly operated markets, reduced social welfare and uneven distribution of wealth. In contrast, Dehejia (2003) attempts to explain why gradualism works when shock therapy did not – it was due to market imperfection in many transitional countries.

McIntyre (2002) makes the point that the transitional economy in East/Central Europe and the former Soviet Union (SFU) were already highly industrialised, urbanized and, in some ways, hyper-modernised before transition. Therefore, although facing many difficulties in the early stages, these transitional countries are now members of the EU and are entitled to receive support from this organization as well as from other international donors (Dallago, 2003).

According to Dallago (2003), the EU was important to these countries in two ways: (a) as a stabilizing and coordinating factor, and (b) as a donor of financial resource. There is a range of supports from the EU: the EU monetary and fiscal policy offers other countries a more stable environment, technical advice, and political support; technology transfer, financial funds; and an opportunity to become part of trans-Europe industrial and trade networks. As a result, development of the private sector, and particularly SMEs, in these countries can result in many benefits.

As discussed by Dallago (2003), the benefits for SMEs in CEE went further than just the accessibility of new markets in the EU, and those benefits included the advantage of expertise transfer, the acquisition of new technology and greater specialisation. However, Dallago also highlights the difficulties, including greater competition and risks for firms that enter the value chain of transnational companies (such as the specialisation in labour-intensive processes and the possible dismantling of the home research base).

2.2 The Asian 'Gradualism' Approach

The CEE 'shock therapy' approach was described by Kartz (1995) as the shift of economic decision making to the private sector, and the exclusion of government intervention in the national economy, or private enterprise operating in a framework of market-determined prices but abolishing the need for public sector involvement at the macro-level in a national economy. Conversely, the Asian 'gradualism' approach is an incremental process, and although private enterprises and free market are seen as drivers of this process, the public sector still cooperates actively in supporting and moderating market-based reform and private sector development at a macroeconomic level (Katz, 1995). Cook, Kirkpatrick, and Nixson (1998) go further by arguing that the main source of private sector development should encompass three major components: privatization, restructuring of large-scale enterprise, and SME development.

3. Privatisation as tool to increase the size of the private sector

Privatization is used as an important tool to reduce the significant role of public sector firms and increase the size of the private sector. Privatization is a 'major instrument of the transformation and particularly the restructuring process' (Cook et al. 1998, p.3). In a different way, Harvie and Lee (2002) define privatization as a divestiture of ownership to develop the private sector.

Yamin (1998) states that privatization is an essential first step in the marketization process. Privatization bloated the size of the private sector and since many of the State Owned Enterprises were SMEs, this considerably increased the number of SMEs in the private sector as well. Assaf (1998) points out that privatization is a major instrument of the transformation since it develops SMEs in CEE and the former Soviet Union. One way to push the creation of new small firms is to break up state-owned enterprises into smaller entities and privatize them (Elleithy and Nixson, 1998).

Dallago (2003) also observes that many successful SMEs in CEE are not new, but are often spin-offs of preexisting state-owned companies or co-operatives or transnational companies. Similarly, Klapper, Allende and Sullar (2002) observe that SMEs in CEE were the result of restructuring and downsizing large firms, privatization, and outsourcing of support services and vertical fragmentation of products. In the same way, in developing countries, privatization began to go faster in the latter half of the 1980s (Cook et al., 1998) and it was economic reforms that were designed to reduce the public sector and develop the role of private market institutions. It is a necessary condition for a centrally planned economy to transfer to a market-oriented economy through the reduction of government ownership power in business.

However, a smaller or weaker public sector may also hinder the growth of the private sector, as experienced by CEE countries when they kept private enterprises operating in a framework of market-determined prices but eradicated the involvement of the public sector, while in Asian countries such as Japan, South Korea, Taiwan and also in the United States, Germany and the United Kingdom, the public sector has played and continues to play a key role in strengthening and supporting the development of a vigorous private enterprise sector and efficient market (Katz, 1995).

To conclude, despite some limitations, it is argued that current trends towards privatization and the declining role of the government have created an improved business environment and have encouraged the growth of a small firm sector (Elleithy and Nixson, 1998).

4. Discussion

4.1 Policy regime in CEE Countries

Support policies for SMEs vary from country to country and from developed countries to less developed countries due to differences in business contexts, culture, and the level of industrialization. Since East European countries are now EU members, there are various EU programmes for SMEs that cover a range of needs. These include vocational training and education, infrastructure projects, individual and information technology development (Konopielko and Bell, 1997). In addition, SMEs in these countries also receive direct support from local authorities and the government. Poland and Bulgaria are cases in point, where SMEs are provided with training and advisory services, management, market information, credit access, exports promotions and the introduction of high-tech production. In the initial stage of transition, these countries suffered some setbacks when SMEs operated in imperfect markets that lacked institutional support. Bulgaria's policy in 2000 (ASME, 2000) was based on two approaches for SMEs, aimed at creating an overall favourable environment and support for the start-up and development of SMEs through direct support. Since SME development is directly related to the existence of a favourable business environment, the key measures of the first approach are: reduction of trade barriers; alleviation of administrative-legal barriers; privatisation and de-monopolization; improvement of the taxation system; and building positive public attitudes and an entrepreneurship culture. The second approach put into practice various programmes of support for entrepreneurs: preparation for starting a business; finance and investment; company growth; quality management; export operations; training and development of staff. Hence, the policies for SME development consist of the following:

- Institutional framework;
- Macroeconomic policy;
- Administrative legal policy;
- Sector, regional and problem-oriented policy;
- Financial support; and
- Support through the provision of information, consultancy and training.

In Poland, the policies to support SMEs can be categorized in four groups: (a) legal and regulatory; (b) financial; (c) organizational; and (d) knowledge dissemination (Surdej, 2000).

Given that the SMEs in East/Central European countries can take advantage of high industrial levels, business support infrastructure, financial support, consultancy and training support, Gibb (1996) concludes that SMEs in these countries have been growing rapidly. The CEE experience suggests that business support infrastructure, financial support, legal and institutional framework, and cluster and network relationships play a vital role in business development.

4.2 Policy Regime in Asian Industrialised Countries

SME development is becoming increasingly important to many industrialized countries such as Korea, Taiwan, Singapore and Australia. The Singaporean government identified four key problem areas of SMEs: access to technology, the work force, finance and the market (Lee and Tan, 2002). In 1998 the Korean government employed a number of policies to foster the growth of SMEs and their involvement in the global economy. This was done by ensuring access to finance, supporting human resource development program, and developing technology and scientific achievements so that business can develop extensive relationships with the global market (Gregory, 2002). According to Ngui (2002), SMEs in Taiwan have the following features: network-based industrial systems; minimum efficiency sizes and entry barriers; and low agency and transaction costs. In Australia, special attention is given to key issues affecting the development of SMEs. These are access to finance, the importance of culture/networking in the conduct of business, access to technology and the adoption of information technology, and progress in human resource development (Nguyen et al. 2002).

The most common key features in Korea, Taiwan, Singapore, and Australia are support for technology and financial access, manpower access and networking. The Korean government paid attention to developing ties between large firms and SMEs and the fact that large and small electronic firms' networks clustered in Seoul is a good lesson for other countries.

4.3 Policy Regime in East Asian Developing Countries

Harvie (2002) identifies the case of TVEs in China as providing important lessons for other economies in transition. To support the private sector, China has reformed its financial system, and its tax and revenue system, enhanced its technical innovation system, improved legal protection of property rights, devised education and training programs, and opened up more sectors for private investment and competition. Harvie (2002) also cites in Garnaut and Song (2000) that there is still much discrimination against smaller and private enterprises in China such as through business registration, taxation, financing and foreign trading rights. Harvie then discusses a numbers of difficulties that the private sector has to face. Those obstacles include: the imposition of arbitrary fees and taxes; unequal access to finance; an inefficient bank lending system; weak managerial skill and employee levels; weak accounting and auditing practices; and insufficient support for private enterprises by different levels of government in registration, land use, finance, market entry and law enforcement. The significant issues of weak levels and the regulatory environment, weak markets predominantly in the financial and labor markets, and the nonexistence of a competitive environment are also vital to be solved. This situation is exactly what is happening in Vietnam during the transitional process and private sector development.

The Malaysian government has supported SMEs by providing financial and credit assistance, assisting entrepreneurial development, improving business management and human resource management, allowing consultancy and marketing services to grow, introducing technical and vocational programs, offering location and infrastructure facilities and providing fiscal incentives (Abdullah, 2002).

In Thailand, the government introduced a financial incentive package, technology development programs, and provision of benchmarks (in technology, marketing, management and governance). Support policies were devised with the intention that SMEs can integrate successfully into various industry value chains or clusters and become involved in more supportive networks such as academic institutions, government agencies and other firms in related and supportive industries (Brimble et al., 2002). This network relationship has created a new information flow and knowledge base for SMEs.

China, Malaysia and Thailand benefited from these policy reforms, network relationships and new support infrastructure. Indonesia's experience suggests that neglect of cluster linkage to markets was one of the reasons for SME failure. That is, economic advantages can only be achieved if the cluster has a well-developed network both internally and externally (Tambunan 2005).

4.4 Lesson learn from other countries

According to the OECD (1997), best practice policies for SME development should focus on five areas:

(a) Financing;

(b) Business environment;

(c) Technology;

(d) Management; and

(e) Access to the market.

For these reasons, irrespective of the country concerned, transitional approaches or industrial background, SMEs still face familiar problems and need adequate aid from government policies, because private enterprise cannot operate in an imperfect market without support from institutions in general or government and the public sector in particular.

Katz (1995) also argues that there are two key concerns for Asia's new transitional economies: the process of transition and institutions of transition. The question of process involves the ability of the country to formulate and implement logical macro-level reform strategies, policies, and measures. The question of institutions involves the role of public sector.

According to Katz, the public sector should involve: (1) commercial law, regulation and enforcement machinery; (2) a central bank and integrated commercial banking systems; (3) essential support infrastructure; (4) respect for non-economic value; (5) international and financial relations; and, finally, (6) a more extensive framework as the key vehicle for economic reform, development and transition.

Drawing a general lesson from the East Asian experience, Petri (1995) points out: (1) there was a steady environment that encouraged investment and enterprise; (2) there were incentives to direct resources and initiatives towards proficient activities; and (3) there were dynamic mechanisms to promote leadership for high-speed development. A wide range of specific institutions and policies helped achieve these critical requirements.

Katz (1995) argues that the transitional countries of Asia – Laos, Mongolia, Myanmar and Vietnam – enjoy a significant economic advantage, since they can learn from the experiences of other transitional countries in Asian and CEE countries with less political change and step-by-step incremental processes. These countries enjoy cheap labor and strategic locations with a reasonably large market in Asia and the Pacific. However, they do not enjoy a high level of industrialization. As a result, the change to a market economy and integration into a global market requires a gradual approach to change. The economic transition and development of SMEs in South East Asian countries requires a well-designed policy package, an infrastructure development program and an effective institutional framework.

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