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Political Economy of the Crisis in Latvia 2008-2010 – Key Contributing Factors

Neo-liberal policy and economic transformation

The severe economic downturn in Latvia, 2008-2010, was provoked by the world financial and economic crisis 2007-2009. It had similarities with many other countries in the world: rapid growth of domestic demand facilitated by borrowing ease from banks, boom of real estate and positive growth expectations of foreign investments. Despite the similarities with other countries, the roots of the recent crisis go down in the annals of the modern history of Latvia. They also open a new scope of debate that contains potential for change in economic thought that eventually could positively influence changes in the political and economic structures of the country.

Latvia and the other Baltic States were the fastest growing economies in Europe following the accession to the EU. GDP growth in Latvia was more than 10% per year during 2004-2007. In Estonia GDP growth in the same period was 4.5% and in Lithuania- 8.1%.1 Between 2000 and 2008 (before the crisis), GDP per capita, measured in Purchasing Power Standards, increased from 37% of the EU average in 2000 to 57% in 2008. According to the official statistics, this was the result of a convergence in indicators of standard of living that started with the prospects of EU enlargement and continued since after. This process could be perceived in two ways: as the outcome of EU integration, but also as a precondition to it.

The apparent success of economic development in the country until 2008 and its economic transformation was based largely on the concept of a neo-liberal economic policy. Latvia since regaining its independence in 1991 along with the other Baltic states, Estonia and Lithuania, has applied the neo-liberal policies of the „Washington Consensus". According to the neo-liberal concept and policy of the Bretton Wood institutions, transformation to a market economy from a centralised and regulated market required implementation of the first generation reforms and institutional changes aimed at building strong macroeconomic fundamentals. Institutional reforms, privatization and restructuring of large enterprises in all branches of national economy, radical fiscal reform, supported by the reform of tax policy and tax administration as well as the reform of budgetary processes, have been done according to a "policy package" suggested by the "Washington consensus" and represented a "shock therapy" policy.[2] The key fundamental suggestions received from the International Monetary Fund (IMF), relates to the establishment of a rigorous macroeconomic framework. Technical assistance, provided by the IMF and the World Bank, permitted for the first-generation reforms to be completed by the mid 1990s.

During the transition period, and the implementation of the first generation reforms (1991-1999)[3], the Latvian economy underwent three major downturns. The first was from 1991-1994 when the economy in 1992 shrunk by almost 35% with a dramatic decline in production and living standards. However in 1994, the rapid decline of GDP in Latvia stabilised. This year can be considered as a turning point and the beginning of the economic success story of Latvia that lasted until the crisis of 2008.

The second downturn occurred in 1995when the internal banking and financial crisis damaged the economic system of the country. In 1996, the economy started to recover. Between 1996 and 1998, economic development began to flourish with an annual growth rates reached 6% of the GDP and represents an example of the conditional convergence theory[4]. By 1997, growth in Latvia was the most pronounced of the transition economies, and the annual economic growth of the country was higher than that of the EU during 1996-1998. However, in 1998, a third downturn took place.

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1 Eurostat. *Flash Estimate* 14 February 2008.

2 John Williamson (1990) What Washington Means by Policy Reform Peterson Institute for International Economics, http://www.iie.com/publications/papers/paper.cfm?ResearchID=486, (5/03/11); Grzegorz W. Kolodko (2002) Post Communist Transition and Post- Washington Consensus. The Lessons for Policy Reforms in Mario I. Blejer and Marko Skreb (eds.) Transition: The First Decade. The MIT Press, Cambridge, Mass.

3 In December 1999 the EU opened negotiations with Latvia about the accession to the EU and the Government of Latvia signed the Joint Assessment with the European Commission on economic policy priorities for the country.

4 Fischer S, Sahay R, A Vegh C (1998) How Far is Eastern Europe from Brussels IMF, WP/98/53, http://mpra.ub.uni-muenchen.de/20059/1/fischer-sahay-vegh-brussels.pdf, 5/03/11

This was the result of the Russian economic and financial crisis of 1998 that had a negative impact on Latvia The 1998 rouble devaluation in Russia forced Latvia to re-orient its exports from Russia and the Common Independent States (CIS) towards the EU countries, and thus abandon what was once Latvia's main export market. However the Russian and CIS markets became problematic for Latvian producers not only as a result of the weakened demand but also due to the strong Latvian currency, subject of the philosophy and independent position of the Bank of Latvia. In the medium term this loss of exports to Russia and the CIS was compensated in part by exports to the EU.

The impact of the Russian crisis on Latvia strongly influenced trade patterns and forced Latvia's producers to reorient trade flows to the EU countries, which grew by 16-17% per year by the time of the EU accession in 2004, and accounted for approximately 50% of Latvian exports re-establishing the pre World War II trade pattern.[5] Steadily a trend of inter-trade with the EU has changed to intra- trade. The second-generation reforms have been implemented with the prospect for Latvia to become a member of the European Union. Methodologically it is aknowledged that the second-generation reform process is focused on real convergence, which requires structural adjustment and overcoming the income gap between Latvia and the EU level.

Related to the above described trends in trade, the Government identified comparative advantages of the country, particularly as far as the product composition of trade is concerned: wood and wood products dominated exports, and the production of these also made a decisive contribution to the growth of GDP. Another important industry was textile. Export of textile to the EU was stimulated by cheap labour cost, as the industry is relatively labour intensive. However, this advantage has eroded over the following years when Latvian wages increased to catch up with Western Europe.

The economic progress of the country required understanding of the emerging composition of production that would have to be complementary or competitive to the structures prevailing in the European Union. Support of those sectors of the economy that should be developed in order to benefit the most from EU membership, was of crucial importance. The economic structure as a whole has been transformed since the transition began in 1991. Post World War II developed large industrial enterprises and industrially based agriculture that has been predominant until the transition started. These have been dismantled with the first generation reforms and, in particular, through the privatization process. Agriculture and manufacturing by 2001 accounted for 14% of the GDP, and the service sector accounted for 70% of GDP.[6] This pattern continued until the crisis of 2007-2010, thus resulting in a serious impediment for Latvia to catch up and become a serious competitor with the countries in Europe. It is important to stress that in Latvia as in some other countries in the EU, service and construction sectors grew rapidly during 2000-2008. At the same time manufacturing lagged behind. [7]

While employment in agriculture and industry has declined, it has risen steadily in construction and in all other service sectors, apart from business and financial services, but including public administration, education and health. Latvia's National Development Plan[8] for 2007-2013 at the time of its preparation in 2006, put emphasis on the development of knowledge-based industries to stress in the future comparative advantages in those sectors, which Latvia has. This complements the traditional timber and textile industries with such sectors as biotechnology, timber chemistry, pharmaceutics - all of which are knowledge based and require high technology.

Latvia has been generally following a set of monetary and fiscal policies demanded by the international market. Free convertibility and the liberal foreign exchange policy have secured competitiveness on the foreign exchange market. The national currency (LVL) was pegged to the SDR in 1991 and since 2004 has fixed the peg rate of the lats to the euro. [9]It has been quite stable since its introduction, and the domestic money supply has 100% foreign exchange

[5] Bank of Latvia, http://www.bank.lv/eng/main/all/sapinfo/presrunas/latviainfocus/, 5/03/11

[6] Ministry of Economy of the Republic of Latvia, 2005

[7] Muravska, Tatjana. Crisis inLatvia- Economic Transformation: The Regional Dimension and Development Constrains (2012) in Adaptability and Change- The regional Dimensions in Central and Eastern Europe, eds: Grezgors Gorzelak, Chor-Ching Goh and Karoly Fazekas, SHOLAR, Warsaw,pp240-263.

[8] Latvian National Development Plan 2007-2013.Ministry of Regional Development and Local Government of the Republic of Latvia, Ltd."Jelgavas tipogrāfija" 2006.

[9] Since the beginning of 1994 when the Latvian currency was pegged to the SDR, the unit of accounting of the Internationally Monetary Fund (1 XDR = 0.7997 LVL). The Bank of Latvia on December 30, 2004, has fixed the peg rate of the lats and the euro

coverage. Exchange rate pegs in Latvia have provided currency stability and significant progress with disinflation. However, when the exchange rate is fixed, the burden of adjustment in response to external shocks, or shifts in relative competitiveness, falls elsewhere on the economy. To the extent that prices or wages are not flexible enough, and the real economy has to adjust.

As a result of comparatively stable and liberal economic policies, the Latvian economy was successful in attracting foreign direct investments (FDI) before the accession to the EU[10]. This had a positive influence on the rapid development of the foreign trade relations. There have been substantial changes in foreign direct investments over time including the modest investments in 1992-1996 that increased considerably in 1997. the greatest gains of FDI were experienced after accession to the EU as the result of a combination of political and economic factors. The major part of FDI influx has been in transport and communication, port facilities, industrial sector, food and wood processing, textiles, chemicals, base metals, metal products and machinery. It is important to mention that FDI has also been significant in real estate and construction

Since accession to the EU and until the recent crisis, the FDI stock more than doubled in both goods and services. In terms of the production of goods, a particularly rapid increase of the FDI has been observed in the energy sector (by almost 5 times), and more than 5 times in the construction sector. The dynamics of FDI was not so rapid in the manufacturing sector and has increased only by 1.5 times.[11] However, the majority of the FDI were financial transactions that are not included in direct and portfolio investment, but represented trade loans, other credits and borrowings, cash and deposits, etc. The biggest share of the financial influx belonged to commercial banks. This trend was stimulated by the open regime of the financial account and the fixed currency exchange rate. Nordic and German banks (Skandinaviska Enskilda Banken, Swedbank, Nordea, DnBNORD) mainly, have increased their stake in ownerships and new acquisitions in the financial sector.

In 2000, Latvia became an integral part of the European banking system. The real time gross settlement system was introduced, which strengthened motivation of financial capital to “settle” in Latvia. Since 2005 the leading position in FDI belonged to financial services. Influx of FDI, as percent of GDP, was the highest (8%) in 2006 and then was reduced to 3% in 2009. The intensity of FDI flows in Latvia, like in almost all countries in the world, is considerably weaker than before the crisis.[12] The high levels of investment were the result of the intensified influx of foreign financial resources into the national economy after accession to the EU, while domestic savings were too low, and cannot be considered as a sufficient source of investment. However, a number of potential risks for the future of real convergence existed and associated with the scale of the current account deficit and inflationary pressures. Stable financing of the current account deficit due to strong flows of FDI plus cross-border credit transfers from Nordic banks to their subsidiaries in Latvia, helped to sustain economic development in pre-crisis period.

At the same time, inflation increased in 2004, rising to 7.3 percent, reached 10% in 2007 and was over 15% in 2008, due in part to the rise in administratively regulated prices[13], the harmonization of indirect tax rates in the context of EU accession, and high world oil prices. A negative factor in stimulating inflation was the growth of private sector credit and real estate. Strong domestic demand and a disproportionate current account balance pushed inflation beyond the

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at 1 EUR = 0.702804 LVL, which took effect on January 1, 2005 in line with the government approved plan for Latvia's preparation for full-fledged membership in the Economic and Monetary Union (EMU). Bank of Latvia, http://www.bank.lv/eng/main/all/monpolicy/ls-euro/cmp1/, 2/04/11

[10] Foreign investors get national treatment, and they are free to engage in any activity, convert and transfer their earnings. Companies established before 1995 received 4-8 years tax holidays. Since 2001, large investments – both domestic and foreign – are eligible for corporate income tax holiday of up to 40 percent of the invested amount, in line with the limit set by EU competition rules. Companies manufacturing high-tech products enjoy a tax holiday of 30 percent of the investment; in the case of small and medium-sized enterprises it amounts to 20 percent. The corporate income tax rate has fallen gradually, reaching 15 percent in 2004. The withholding tax on dividends amounts to 10 percent.

[11] Ministry of Economy of the Republic of Latvia, 2004-2008.

[12] Ministry of Economy of the Republic of Latvia, 2011.

[13] According to the data provided by the Central Statistical Bureau, in 2008, 11.46% of all goods and services listed in the Consumer Price Index were services with administratively regulated prices. These include services that are regulated by the Public Utilities Regulation Commission, services that are regulated by local government regulators, as well as other services that have regulated prices.

10% threshold. In 2010, the annual inflation reached 2.5%. The main contributors to the inflation was the prices for energy and food. For example, petrol prices rose by 14.2%, whereas diesel fuel went up by 19.9%; heating increased by 19.4% and natural gas by 16.3%; food prices went up by 8%.[14]

The economic downturn started in the first half of 2008 and originated in the reversal of the domestic real estate boom. This worsened rapidly and affected GDP growth rates, which dropped to 4.6% in 2008. The hardest downturn was in retail, real estate and construction. The budget deficit was 1.6% of GDP in before the accession in 2003 and below 1% of GDP every year after 2004, before rising to 4.1% in 2008 and 9% in 2009. The budget deficit was narrowed to 7.6% (targeted at 8.5%) of GDP in 2010, and for the 2011 it was projected at 6 % of GDP and 3% in 2012. [15] Latvia's current major financial policy goal is to enter the euro zone by 2014.

Large domestic consumption as a result of liberal credit policy by banks (majority of them are Scandinavian crediting institutions) in Latvia, was one of the reasons for the loan- giving boom in the country when foreign currency loans have dominated. Experts from the European Commission, IMF as well as the European Central Bank have already stressed the danger of this situation prior to the crisis, but the ruling parties ignored warnings from the international financial community that the economy was dangerously 'overheated.' Too little was done and too late to avoid an almost inevitable catastrophic outcome in terms of a 'hard landing'.[16]

Unfortunately, the government's decision to limit housing loans through the requirement for buyers to provide co-funding in the value of at least ten per cent of the value of the purchase and the proof of taxed income from the State Revenue Service, was introduced too late. The Credit Register of the Bank of Latvia was also created only in 2007 and launched in 2008.[17] In addition, the Latvian population is still lacking experience in adjusting to the new rules of a market economy imposed by the neo- liberal approach to economic development, which resulted in an unjustifiably high increase of housing and other types of loans.

The catalysis of the rapid economic downturn was the announced insolvency in November 2008 of the second largest bank by total assets and the only Latvian commercial bank - Parex Bank. Despite the nationalisation of the bank, rapid capital outflows continued and the government introduced deposit withdrawal restrictions. Consequently, non-resident deposits had in general decreased by 19.2 % in one year by December of 2008 in Latvia[18]. In general, the global financial turmoil put a blockage on credit channels, and investment flows into Latvia drained off. The Parex Bank case very seriously affected this process. The FDI according to the Central Statistical Bureau amounted 23.5 million euro in Q1 of 2009, down almost 94 % from 371 million euro in Q1 2008. CSB data shows that the adjusted GDP figure for the first quarter of 2009 was -18.0%. International experience shows that economic growth has not always been a symptom of economic overheating. The so-called "overheating" of the Latvian economy was and continues to be discussed by experts. However, no forecasts have been made for such deep downturn as Latvia experienced.

On 23 March, 2010, the Latvian Cabinet of Ministers approved the restructuring plan of Parex Bank and later submitted the plan to the European Commission. According to the plan, a part of the Bank's assets were used for the creation of a new bank, Citadele, with a stable financial base. The decision envisages that until 2014, no additional state budget funds, apart from the Treasury's deposit for capitalisation in the amount of 146.55 million euro for financing equity

[14] Central Statistical Bureau of Latvia (CSB), 2011.
[15] CSB April 18, 2011; Declaration of the Intended Activities of the Cabinet of Ministers of the Republic of Latvia, http://www.mk.gov.lv/en/mk/darbibu-reglamentejosie-dokumenti/valdibas-deklaracija-eng/ ,20/04/11
[16] IMF (2008) World Economic Outlook: Housing and the Business Cycle, April 08. Washington DC: International Monetary Fund, http://www.imf.org/external/pubs/ft/weo/2008/01/index.htm, 9/01/11.
[17] Bank of Latvia, http://www.bank.lv/eng/main/all/lvbank/register/register/, 9/01/11
[18] The Parex Bank restructuring component required large funding as the Parex Bank (assets equivalent to more than 20% of GDP) was taken over by the government following a run on deposits and the consequent need to avoid default on the 775 million euros ($1 billion) of syndicated credits due in 2009. The problems at Parex Bank were one of the main reasons for Latvia to apply to the IMF and EU for financial help, since the syndicated credit had the right to demand repayment of the debt immediately following a change in ownership at the bank, and the government needed the institutional support to be able to renegotiate and rollover the debt. As a result the Latvian authorities have been able to issue guarantee for the refinancing of syndicated loans of EUR 775 million due in 2009 (euro 275 million in February and euro 500 million in June). The risk of further deposit withdrawals from Parex Bank, especially by non-residents, will continue despite the effective nationalisation of the bank. At present negotiations with the EBRD take place for EBRD to become a partner of the Bank.

capital during the division phase, will be needed. The decision does not provide for any other additional investment of state capital in the Parex Bank or the separated bank. Prime Minister Valdis Dombrovskis stated: " Parex Banka has received state aid in amount of.565 billion euro, and the decision provides for no more than 1.85 billion euro of aggregate state investments, including guarantees. The amount is based on calculations by the Finance Ministry and the Latvian Privatisation Agency as adequate for ensuring sufficiency of both banks – the Parex Bank and another bank that was separated from the Parex Bank. Harmonisation of these decisions with the European Commission ensured that the restructuring model is viable and will not distort competition in the EU internal market. The previously widespread policy of lending without any in-depth research into a loan applicant's credit history was suddenly replaced by a much more cautious approach. Together with an increase in value-added tax, this has profoundly influenced consumer behaviour.

In just a year, the economic boom was replaced by a crisis that made foreign borrowing unavoidable. A government programme to restore confidence and macroeconomic stability has been initiated based on an agreement with the IMF. This programme involves a .5 billion euro injection of liquidity into Latvia, including contributions from the EU, the IMF the Nordic countries, and the World Bank.19 It is widely acknowledged by experts and the public in Latvia that fiscal management carried out by the government of Latvia prior to the crisis was pro-cyclical and immature. This could be explained by the behaviour of political coalitions aimed at the redistribution of the state budget funds as a result of the implementation of supplementary annual budgets at the end of the fiscal year, which always increases government spending. As a result, the economy suffered from imbalances. Having the EU's highest GDP growth until 2007, largest credit expansion, house price increases, and high inflation, Latvia has currently the largest account deficit of all EU states as well as the highest private sector debt in the CEEC.

Labour market and economic democracy

Social protection and employment policies represent two conflicting trends in the context of socio-economic system development. this represents another feature in the building of a market economy in Latvia. The experience of the country can contribute to the modern conceptual debate in Europe of economic democracy and the transition from the capitalist welfare state to democratic socialism. The major themes under consideration are focused on the free market, market socialism and socialisation of the market.

These debates are determined to great extend by the 'Swedish Model' of socialism and theories of Gösta Rehn, one of the fathers of the 'Swedish Model', and Rehn-Meidner Model' Rudolf Meidner. The most influential economic model of the twentieth century is known as the 'wage earner funds[20]. As a result of the economic crisis in the 1970s and 1980s and its consequences, these models became the most widely used in the Old Member States in the EU. The fundamental question remains whether market forces should play a central role in the economy or whether they should function under the pressure of democratic decision making.

The socio-economic democracy concept[21] is foreseen through the implementation of social policy and social protection. This concept is aimed to minimise a potential conflict in the decision making process on the subject of the wealth distribution in a society and is focused on such issues as the concentration of wealth and democratic principles. A macro-level approach to this dilemma requires the involvement of a government to develop a mechanism for harmonisation of the interests of different social groups. Besides, this approach requires certain strategies for the transformation of power and property by the promotion of further democratisation of a welfare state and public sector, corporative management, cooperatives and self-management.

[19] The authorities reaffirmed their commitment to putting the budget deficit on a rapidly declining path from 2010 onward in order to meet the Maastricht criteria for euro adoption as quickly as possible;
IMF, http://www.imf.org/external/np/sec/pr/2010/pr1047.htm, 5/04/11

[20] Brian Burkitt, Phillip Whyman (1994). "Employee Investment Funds in Sweden: Their Past, Present and Future", *Journal: European Business Review*, vol. 94, no 4, pp. 22-29; Lennart Erixon (2008), "The Rehn-Meidner Model in Sweden: Its Rise, Challenges and Survival" , Department of Economics, Stockholm University, http://www.ne.su.se/paper/wp08_02.pdf, 9/01/11

[21] Economic democracy is a concept that was developed in the 19th and 20th centuries with the main idea to apply democratic principles in an economic system.

Countries that have rather regulated economies and apply contra-cyclical measures experienced much less turbulence during the recent crisis. For example, Germany, Austria, the Scandinavian countries and Canada. These countries pursued the classical path of protection of domestic industry, public infrastructure spending, banking system regulations, and progressive taxation, public health and workplace safety regulations.

In Latvia, neo- liberal policy and the path of the radical free market economic reconstruction did not provide provisions of an inclusive welfare state system. Development of social dimension in Latvia before the accession to the EU was significantly influenced by a conflicting trend of social protection and employment policies. Nevertheless, international organisations such as the World Bank, United Nations Development Programme, International Labour Organisation and the European Union suggested and implemented programmes and projects that help to establish a legal framework required to provide a social safety net system. Despite the fact that Latvia has signed several international agreements on human rights, welfare as well as social protection[22], Latvian legislation does not provide an explicit definition of the term 'social protection'[23]. It is important to stress that major legislative steps to develop the social protection system were taken in the pre-accession period. The accession period required the design and implementation of the National Employment Plan launched in 2004 and National Action Plan for Reduction of Poverty and Social Exclusion (2004) that was in line with the Single National Economy Strategy (2004-06) Joint Memorandum on Social Inclusion (2003)[24]. The Ministry of Welfare in Latvia has issued two important strategic documents: the "Conception of the Development of Labour Protection from 2007–2013" and "The Programme for Development of Labour Protection from 2007-2010". At the same time, while the economic development aspect and its various components are fully recognized, the social dimension is more diffused and not always fully integrated in the development process. This increases the risk of increasing the lack of public confidence regarding the stability and sustainability of the safety net system in general.

A controversial issue in the development of the pension system was the complete transfer of administrative rights of the state's funded pension funds to the private sector. It has lead to a high concentration of financial resources within the private pension plans and investments of these resources abroad, especially the US bonds. consequently, these resources are not facilitating development of Latvian national economy, but rather working against the Bank of Latvia intervention policy. The increase in economic activities since 1999 has witnessed a significant degree of convergence. Latvia appeared to have a clearly positive development of GDP per capita from 2005 to 2007 and rose above 50% of the EU average.25

Over the period from 2003 and until the crisis in 2008, the employment rate increased by 6.5 percent and the unemployment rate decreased by 4.5 percent. The number of average yearly benefits recipients decreased slightly every year after EU accession, following the general trend since 1999. On the contrary, the average unemployment benefit and the associated social insurance expenditures gradually increased. The rise in the unemployment benefit is linked to increase of wages in the economy, but also to more legalization of employment (or rather paying social insurance contributions from full salary, reduction of prevalence of " envelope wages").

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[22] The Universal Declaration of Human Rights, United Nations General Assembly resolution 217 A (III) from10 December 1948.European Social Charter, Council of Europe Treaty, adopted in 1961, revised in 1996. (http://www.hrcr.org/docs/Social_Charter/soccharter.wpd). Constitution of the Republic of Latvia (1992), as amended, www.likumi.lv 9/01/11 assures that everyone has rights to social security when old or in the case of work inability or unemployment.

[23] EC Regulation Nr. 322/97 art.2.

[24] National Employment Plan (European Foundation for the Improvement of Living and Working Conditions. www.eurofound.europa.eu/areas/qualityoflife/eurlife/index.php?template=3&radioindic=dDomain=3 3/03/11 and National Action Plan for Reduction of Poverty and Social Exclusion (2004-06 (accepted on July 23, 2004), that was in line with the Single National Economy Strategy (2004- 06), /Tautsaimniecības vienotā stratēģija, 2004/.www.likumi.lv/doc.php?id=72377 3/03/11; Joint
Memorandum on Social Inclusion (2003), prepared by Latvia together with European Commission (JIM), signed on December18, 2003. The Ministry of Welfare in Latvia has issued two important strategy documents: the "Conception of the Development of Labour Protection from 2007–2013" and 'The Programme for Development of Labour Protection from 2007–2010".

[25] Eurostat. 2008, http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-SF-08-112/EN/KS-SF-08-112-EN.PDF, 3/03/11

The expenditures on social protection have been steadily increasing since 2000 reaching almost 2 million euro in 2007. However, this expenditure was around 30% in 2007 in Belgium (30.1%), Denmark (29.1%), Germany (28.7%), France (31.1%), the Netherlands (29.3%), Austria (28.5%) and Sweden (30.7%), and below 15% in Latvia (12.2%), Estonia (12.4%) and Lithuania (13.2%). These disparities reflect differences in living standards and also indicatives of the diversity of national social protection systems and of the demographic, economic, social and institutional structures specific to each Member State[26]. Accession to the EU has promoted discussion on health and safety issues at the workplace as the accession has re-opened inherent tensions in the EU policy making in health and safety as a result of incompatible two objectives: the need to ensure broad member state compliance with regulation around agreed minimum standards through active regulatory enforcement and the promotion of voluntary initiatives in the management of work place risks and hazards in order to create "a culture of prevention".

According to the European Agency for Safety and Health at work and estimating EU labour forces is approximately about 220 million. The fatalities rate per million are at 25 in the EU compared to over 50 in Latvia. The estimated cost of work place accidents in the EU is 20 million euro per year. For Latvia alone it is approximately 100 million euro per million workers. However, in view in the more than double workplace accident rates in Latvia using fatalities as an indicator, the cost of workplace accidents in Latvia may exceed 200 million euro. Thus, workplace accidents represent not only human tragedy, but also a major economic burden that must be addressed urgently. As a result of the crisis, at the end of 2009, the ration of jobseekers exceeded 20% of the economically active population and wages decreased significantly, especially in the public sector. Due to the labour market and crediting conditions, disposable income of the population decreased. Government expenditure was substantially limited in order to reduce the budget deficit, which rose due to declining tax revenues. Unemployment has continued to increase. In June 2010, the average seasonally-adjusted unemployment rate in Latvia was 20%.[27]

Social exclusion and poverty are not sufficiently recognised in the country and regional disparities in economic development remain very significant with the factor of almost 2 to 1 (comparing Riga with the rural areas). Since the income in the country has increased the number of people receiving social support from he municipalities has been reduced by 2/3 between 2004 and 2007 –from 74700 to 26800 people.[28] the current economic crisis conditions have undoubtedly worsened further and in turn will negatively influence the demographic situation and labour-market in the country.

The social assistance available to reduce poverty compared to the EU has always been considerably lower and trends indicate the deterioration of the situation. In the EU -27 through social assistance, the at-risk-of-poverty rate is reduced from 26% to 16 % while in Latvia in 2004 the reduction was from 26 % to 19% and in 2007 from 27 to 21%. [29] The State Employment Agency is the main institution involved with unemployment issues and implementing active labour market policies, including the European Social Fund projects. special support has been granted to the unemployed from socially vulnerable groups – persons with disabilities, long-term unemployed, persons with less than general secondary or professional education, elderly (over 50 years), people with one or more dependents and ethnic minorities. These activities are co-financed by the European Social Fund.

[26] Evidence suggests that in Europe there is a general tendency for countries with relatively high levels of GDP per head to have a more equal distribution of income (as measured by Gini index), whereas with rapid economic development also the Gini index increases, i.e., the gap between the rich and the poor increases. In Latvia the Gini index s increasing by about 1% every year since 2004 widening social gap in Latvian society. Income is more equally distributed in most EU Member States than in Latvia. The Gini index in 2004 in EU was 32.7, while in Latvia – 35.5, which compares to US at 35.7.
Regional analysis of Latvia's per capita GDP reveals another cause for concern: increasing regional disparities in personal disposable income. The Gini index measuring inequality in the distribution of per capita disposable income in 2006 was 0.36 compared to a level of 0.30 in 1996.

[27] CSB, 2010.

[28] Ministry of Welfare of the Republic of Latvia, 2008.

[29] Eurostat Database. In the "Laeken Poverty Indicators" to monitor progress in the fight against poverty and social exclusion, the income threshold used to measure poverty was fixed at 60 percent of the national median income in each member state. This is similar to the concept of the EU Regional and Cohesion policies. The absolute poverty line defined by the World Bank is not relevant to this context. See for more information World Bank Report No.38437 LV "Latvia: Sharing the High Growth Dividend A Living Standards Assessment", Poverty Reduction and Economic Management Unit Europe and Central Asia Region, March 28, 2007.

Economic out-migration of the working population from 15 to 65 years old, including people of reproductive age from 15 to 49 years old, has intensified during the crisis.[30]. Major reasons for migration are the following: income level, unemployment and poor social security system, quality of life and lack of career opportunities. Eurostat estimates[31] by 2030, the population of Latvia is expected to fall to 2 million, and to 1.8 million by 2050. The proportion of the population over 65 years was 17% in 2008 (12.7% in the EU), but is expected to rise to 22% in 2030, and 34% in 2060. The old age dependency ratio[32] is expected to reach as high as 65% in 2060. In addition, life expectancy is also growing which means that people over 80 years old is increasing. The proportion of the population that has survived to live over 80 will increase from 3.6% in 2008 to 12% in 2060. The economically active population will fall, and the inactive population will grow. This means people will have to become more productive to provide for the living conditions of the elderly based on the current level.[33] It may also turn out to be the case that it will not be the young people who will care for the old, but rather the old who will care for the even older.

Lack of labour is an important constraint to consider for economic recovery and the further development of the country. In itself, the demography implies increasing social budget requirements including a need for more healthcare, social houses, care work. Social policy decisions such as potentially increasing the retirement ages also required but heavily debated in Latvia and amongst World Bank experts. It is obvious that in order to prevent further population outflows ,attention must be focused on making Latvia a more hospitable place for its own people to live and work which requires effective policy choices for sustainable development, and Cohesion policy implementation; given that the country's human resources for successful economic restructuring are limited.

However, the administrative implementation of the social and employment policies is a complex process and requires the active involvement of a number of government departments and agencies such as the Ministry of Welfare, Ministry of Health, State Employment Agency and etc. It also requires ensuring a social dialog with the stakeholders. Currently, the EU policy makers are confronted by conflicting social and economic goals, i.e., high levels of productivity and growth and the maximization of social protection, inclusion and cohesion. However, the EU Social policy and the Lisbon Strategy can be a tools for EU Member States in the process of adapting to the more competitive environment brought by the new economic environment that resulted from the crises and expectance neo-liberal policies for development of this is critically important for the further reform of the European social and employment policies. Given the diversity that exists, reform can only be addressed at the national level.

Conclusions

The crisis clearly shows, that the model of a service-based economy and excessive dependence on foreign finance and cost advantage, did not create an immunity to the crisis. National economic policy should be ready to react proactively and take contra-cyclical measures. The Government and Parliament should work together and respond to the current crisis in improving legislation that will foresee legitimate actions to respond to economic disasters, by having financial reserves to keep macroeconomic fundamentals strong.

[30] The average estimated number of people, leaving country in 2009, might be average 30 000 persons. Between 2004 and 2008, 76 000 social security numbers were granted in the UK and Ireland to persons from Latvia; another 4 000 were registered in other countries of the EEA. After a peak in 2005, workforce emigration slowed down in 2006-2007 and regained momentum in mid-2008 and especially 2009. According to CSB, the number of people leaving a country for a purpose of living or working in 2008 had 43,6% increase comparing to 2007. The number of Latvian citizens and non-citizens registered in the UK in the 1st quarter of 2009, namely 4 400, was much higher than in any other quarter. Even in Ireland, which has been particularly hard hit by the crisis, the number of registered persons from Latvia in the first 8 months of 2009 was the same as in the corresponding period in 2008, namely 2 500. Countries of destination: Great Britain, Ireland, Northern Europe and Germany. Mostly viewed workplaces by sectors and groups of professions are: occupations in agriculture, forestry and fishing, construction accommodation and food services, transportation sector and human health.

[31] EUROPOP, 2008, convergence scenario.

[32] Old-age dependency ratio - number of persons aged 65 and over expressed as a percentage of the projected number of persons aged between 15 and 64.

[33] Cunska Z., Muravska T. Cunska Z. Muravska T. (2009) "Social Policy Implementation in Latvia: Post EU Accession" in Promotion of Social Policies- an Investment in the Future, Riga: EC Representation in Latvia and the University of Latvia.

The current economic situation requires fulfilling a dual task: to maintain the long-term goals of the social policies and to respond to economic and social challenges. The EU Social policy and the Lisbon Strategy can be tools for EU Member States in the process of adapting to the more competitive environment brought by globalisation and current crisis. The fundamental question remains whether a pure neo-liberal approach to economic development, or a more ridged set of state regulations related to economic behaviour of private companies and financial institutions, taking into account the democratic decision making process, should be implemented in Latvia?

Economic democracy as a concept that was developed and strengthened at times of economic crises in many EU countries should be also implemented in the New Member States, according to the same principles as in the other European countries. The challenge to balanced economic and social policies agendas is also a major challenge in countries struggling for economic and social convergence with the rest of the EU, as is the case for Latvia.

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Estonia's Roller Coaster Ride

Introduction

The restoration of independent statehood and the collapse of the Soviet central planning system in 1991 allowed for a renaissance of Estonia's national economy. According to estimates of the *European Comparison Program*, Estonia's GDP per capita at current prices was only 5 per cent of that of Austria in 1993.[1] Austria's purchasing power parity (*ppp*) was five times greater than Estonia's. Such a significant backlog was typical of all European post-socialist countries (Table 1).

Table 1: GDP per capita in some European Post-Socialist countries compared to Austria in 1993 (Austria = 100)

	On *ppp* basis	At current prices
Slovenia	48	28
Czech Republic	44	13
Hungary	31	16
Slovak Republic	30	9
Belarus	26	6
Russia	26	2
Poland	24	10
Bulgaria	22	6
Croatia	20	11
Estonia	**20**	**5**
Lithuania	19	3
Romania	19	5
Ukraine	17	3
Latvia	16	4
Moldova	12	1

Source: Bundesministerium für Wirtschaft (1996)

It was difficult to believe that the Baltic countries' economies could return to Western European levels after 50 years of Soviet annexation. The open scepticism dominated the thinking of politicians, economists, and Sovietologists. Jürgen Nötzold represented such a point of view:

"The destruction of a unitary monetary system and an economic area with an integral economic system leads to the decline in production and income and to increasing socioeconomic destabilization caused by the collapse of the planned economy. It may be assumed that at least half of the decline in outputs has been caused by the interruption of trade between the descendant countries of the Soviet Union. … The marketing of their [Baltic countries] products remains dependent of the CIS markets. The exports of animal products can be reoriented to Western Europe but only if open markets can be found there. In industrial good exports, nothing can replace the CIS markets. The continuing economic decline in the CIS countries and the insufficient qualification of industry for export in the West leads the Baltic countries to continuous economic stagnation. The maintenance of economic relations with the successors of the Soviet Union, primarily with Russia, need not mean membership in some economic or monetary alliance, but association agreements with Russia are still indispensable." (Nötzold 1993: 55). The bottom year of the transition crisis in Estonia was 1994. According to estimates of the EBRD, the GDP (on the basis of ppp) in that year was 62 per cent of the level of 1989 (EBRD database). The fall in Estonia, moreover, was even one of the smallest of the former Soviet Union's territory, and Estonia's economy was one of the first to grow. Since 1995, it is possible to follow an unbroken path of

[1] According to Statistics Estonia, the GDP per capita of Estonia was 976 euros or 1,155 US dollars in 1993.

GDP growth, with a short exception in 1999, when the Russian crisis caused the GDP to decline 0.3 per cent. Exports to Russia fell 43 per cent (total exports 0.6 per cent) that year. The Estonian economy exited quickly from the Russian crisis, however, and the growth rate for the year 2000 was already 10.0 per cent – the highest among post-socialist Central and Eastern European countries. This cyclical growth lasted until 2008.

From acceleration to overheating

Since the mid-1990s, Estonia has successfully integrated into the global economy. Together with political integration into the European Union (and to NATO as well), Estonia's credibility as an attractive place for investors – both foreign and local – has increased rapidly. A huge inflow of foreign direct investment and an excessively expansive credit policy of commercial banks, financed by their parent banks abroad, followed Estonia's accession to the European Union and NATO in 2004. All of the biggest Estonian commercial banks were subsidiaries (Swedbank, SEB, Sampo Bank) or affiliated branches (2005 entered Nordea Bank) of Scandinavian banks. The share of the three subsidiary banks in the total assets of the Estonian residential banks was 96.9…97.8 per cent in 2003–2007.2 Within three and half years (from the end of June 2005 to the end of 2008), the net liabilities of commercial banks to foreign credit institutions increased 11-fold, from 526 million Euros to 5.9 billion Euros. The amount of the banks´ liabilities to their parent banks reached 9 billion Euros before the global financial crisis (see e.g. Eesti Pank. Financial Stability Review. 2011: 28). The ratio of their net liabilities to foreign credit institutions to GDP increased from 3.7 per cent in 2003 to 36.8 per cent in 2008. This reveals a huge difference between the Baltic countries and Central European post-socialist countries.

Domestic credit to the private sector in Estonia, Latvia and Lithuania increased 2.5, 3.4, and 4.9-fold during the three years after joining the European Union (2005–2007; in the five Central European countries, the increases were "only" 1.5…1.8 times – Table 2).

Table 2: Monetary expansion in Baltic and some Central European countries

	2004	2005	2006	2007	2008	2009
Domestic credit to private sector (y-on-y, in per cent)						
Estonia	**30.0**	**32.5**	**40.7**	**32.6**	**7.9**	**-4.9**
Latvia	40.0	67.6	53.4	32.9	17.9	-10.5
Lithuania	32.0	56.1	34.9	40.6	17.4	-7.1
Poland	4.2	13.8	23.0	27.0	32.5	8.6
Czech Republic	0.1	1.7	22.0	19.5	…	…
Slovak Republic	14.1	14.9	23.3	20.3	25.5	-10.9
Hungary	14.1	16.3	18.5	12.8	18.5	-3.5
Slovenia	24.1	20.2	21.6	24.9	14.9	7.6
Domestic credit to private sector (as a percentage of GDP)						
Estonia	**39.6**	**56.6**	**76.5**	**86.1**	**91.7**	**…**
Latvia	50.3	67.8	87.0	88.3	90.1	103.3
Lithuania	28.8	40.9	50.1	60.4	63.0	69.8
Poland	31.0	33.4	38.5	44.6	55.0	55.2
Czech Republic	31.6	35.7	39.9	…	…	…
Slovak Republic	30.4	35.1	38.7	42.4	44.7	51.1
Hungary	44.5	49.9	54.4	59.5	67.3	66.5
Slovenia	48.1	56.3	65.8	78.8	85.2	92.7
Broad money (M2; y-on-y, in per cent)						

[2] The market share of the two biggest resident banks (*Swedbank* and *SEB*) and the two biggest affiliated branches (*Nordea Bank* and *Danske Bank* as successors of *Sampo Bank*) was 90.1 per cent at the end of 2010 (as a percentage of total assets).

Estonia	**16.6**	**42.4**	**27.6**	**14.1**	**6.2**	**0.8**
Latvia	26.9	38.7	39.7	14.4	-4.4	-2.8
Lithuania	21.4	31.9	21.5	21.4	-0.4	0.7
Poland	7.5	12.6	15.9	14.2	20.2	8.2
Czech Republic	4.5	10.6	13.7	16.3	8.3	…
Slovak Republic	5.7	5.8	8.2	11.8	5.5	6.4
Hungary	9.9	13.0	11.8	8.6	10.8	-0.8
Slovenia	6.6	7.8	8.2	10.6	5.2	0.4

Source: EBRD (2011)

The supply of broad money (M2) increased in Estonia 107 per cent, in Latvia 122 per cent, and in Lithuania 95 per cent over the same period. By comparison, in Central European countries, the increase was 28…49 per cent. Table 2 also answers the question: "Why Slovenia got the Euro in 2007 (and Slovakia in 2009) but Estonia and Lithuania failed?"

The growth rates of GDP neared double digits (9.4 per cent) in 2006 and reached them (10.6 per cent) in 2007. These figures were among the highest in post-socialist Europe (Table 3). The positive impact of the accession to EU on economic and social development is characteristic of all post-socialist member states of EU (see e.g. Alber et al., 2010).

Table 3: Real GDP growth rate in some post-socialist European countries (in per cent)

	2004	2005	2006	2007	2008	2007/2003
Estonia	**7.2**	**9.4**	**10.6**	**6.9**	**-5.1**	**39**
Latvia	8.7	10.6	12.2	10.0	-4.2	48
Lithuania	7.4	7.8	7.8	9.8	2.9	37
Poland	5.3	3.6	6.2	6.8	5.1	24
Czech Republic	4.5	6.3	6.8	6.1	2.5	26
Slovakia	5.1	6.7	8.5	10.5	5.8	34
Hungary	4.5	3.2	3.6	0.8	0.8	13
Slovenia	4.3	4.5	5.9	6.9	3.7	23
Bulgaria	6.7	6.4	6.5	6.4	6.2	29
Romania	8.5	4.2	7.9	6.3	7.3	30
Croatia	4.1	4.3	4.9	5.1	2.2	20

Source: Eurostat

The growth, however, was unbalanced and largely statistical. "The Economist" characterised this "development" ironically: "Your money, my growth" (The Economist 2007: 30). Foreign money inflow created new jobs, but first and foremost in closed sectors like construction and retail trade. From the total increase of employment of 49,700, construction and trade accounted for 44,700 persons. Estonia reached full employment. The labour market turned into the employee-market. Wages skyrocketed and generated additional inflation. This was similar to Germany in the 1950s, which Ludwig Erhard characterised as the time of Kopfjäger [head hunters] (Erhard 1990: 81–82). In 2007, the quarterly growth rates of average wages were more than 20 per cent (y-on-y). On the other hand, domestic demand was driven by active lending stimulated by the overall optimism in the economy and society as a whole and by the expansive "cheap" credit pressure from banks 'fighting' for the clients.

The rapid growth of wages and increased confidence led to a typical backlog of demand and generated an acceleration of demand-pull inflation: between January and October 2008, the HCPI on y-on-y basis was more than 10 per cent. In a currency board system, the ability to manage the complications of extremely rapid inflows of foreign currency (see Table 4) was limited. A single increase of mandatory reserve obligations by the central bank from 13 to 15 per cent

from 1 September 2006 did not play a role anymore. So the surplus of the state budget – to replace every Estonian kroon that was withdrawn by the surplus of the budget the banks threw to the market additionally four kroons.

Table 4: Key indicators reflecting the overheating of Estonia's economy

	2003	2004	2005	2006	2007	2008	2008/ 2003
GDP real growth (%)	7.6	7.2	9.4	10.6	6.9	-5.1	32%
HCPI (%)	1.4	3.0	4.1	4.4	6.7	10.6	32%
Producer price index of industrial output (%)	0.2	2.9	2.1	4.5	8.3	7.1	27%
Construction price index (%)	3.7	6.5	7.3	10.3	12.7	3.4	47%
Average monthly gross wages growth (%)	9.4	8.4	10.8	16.5	20.5	13.9	92%
Current account deficit (bn EUR)	1.0	1.1	1.1	2.1	2.6	1.6	
Current account deficit (% of GDP)	11.3	11.3	10.0	15.3	16.2	9.8	
Gross external dept (bn EUR)	5.6	7.5	9.7	12.9	17.4	19.0	240%
Net liabilities of credit institutions on foreign credit institutions (bn EUR)	0.3	0.5	1.0	2.7	4.8	5.9	1732%
Loan portfolio of individuals with credit institutions (bn EUR)	1.2	1.9	3.2	5.2	7.0	7.7	527%
… for comparison: deposits of individuals with credit institutions (bn EUR)	*1.5*	*1.7*	*2.3*	*3.0*	*3.4*	*3.8*	*154%*
Increase of loan portfolio of individuals with credit institutions (%)	48.0	52.3	70.0	62.9	33.9	11.1	527%
Growth of money supply (M2; %)	9.9	16.6	42.4	27.6	14.1	6.2	157%
Growth of revenues of general government (%)	13.3	8.5	14.1	22.6	21.1	2.0	87%
Growth of expenditures of general government (%)	9.2	8.4	14.2	19.8	21.0	18.0	112%

Source: Statistics Estonia, Eesti Pank [Bank of Estonia]

This money concentrated more and more into the real estate business and through this sector into construction. Such a process had similar futures to crowding out phenomena on the financial market. The number of persons employed in construction doubled within a couple of years and reached the maximum of 87,400 in the third quarter of 2007. The share of construction workers in the total number of employed persons reached 13.2 per cent (Table 5). New construction workers were mostly unskilled, unemployed workers or former policemen, rescue workers, teachers, etc. who were looking for higher wages. The value added in construction increased 192 per cent over 2003–2007 (e.g. in manufacturing 65 per cent and in the Estonian economy on average 78 per cent; Table 6).

Table 5: The number of employed persons in construction and their share in total number of employed persons

	Number of employed persons (thousands)				Percentage of employed persons (per cent)			
	I Q	II Q	III Q	IV Q	I Q	II Q	III Q	IV Q
2003	40	41	48	48	6.9	6.9	7.8	8.0
2004	48	43	51	49	8.2	7.3	8.6	8.1
2005	44	46	53	52	7.4	7.6	8.6	8.5
2006	53	62	66	75	8.3	9.5	10.1	11.5
2007	74	83	87	84	11.4	12.6	13.2	12.9
2008	82	85	83	75	12.4	13.0	12.5	11.4

Source: Statistics Estonia

Table 6: Growth of value added by economic activity (current prises; 2003=100)

	2004	2005	2006	2007	2008	2009	2010
Agriculture, forestry, fishing and hunting	107	112	119	142	128	100	142
Mining and quarrying	104	114	133	169	177	182	203
Manufacturing	106	121	142	165	167	122	151
Construction	114	157	228	292	277	186	161
Wholesale and retail trade; repair of motor vehicles etc.	111	130	155	179	171	140	143
Hotels and restaurants	115	142	164	185	189	144	143
Transport, storage and communications	109	114	131	144	150	133	146
Financial intermediation	111	120	156	195	203	138	158
Real estate, renting and business activities	113	138	162	191	202	175	175
Value added total	110	127	151	178	184	154	163

Source: Statistics Estonia

Estonia's economy overheated, which weakened its competitiveness in foreign markets. A decrease in the growth rate to developed markets can measure these tendencies: the Estonian exports to EU-15 and EFTA countries increased 9.5 per cent over two years (2006 and 2007). At the same time, exports to the third countries increased 64.6 per cent. We have to agree with the conclusions made by EBRD:

„A key explanation for the rise in core inflation lies in capacity constraints in the region´s labour markets. Employment has expanded rapidly in recent years and unemployment rates have fallen to historically low levels. In all but six transition countries, the unemployment rate in 2007 had fallen below 10 per cent, while in eight countries it was below 5 per cent. Strong demand for labour accounts for most of these developments, although demographic factors and migration have also played an important role; substantial labour emigration has been recorded in recent years in Bulgaria, Latvia, Lithuania, Moldova, Poland, Romania and the Caucasus region [this was not so typical for Estonia]. Tightening labour market conditions have led to greater wage pressures throughout the transition region. In most countries annual real weight growth has risen well above 10 per cent without corresponding labour productivity gains. In fact, a significant gap has opened up since 2005 between real wage and labour productivity growth in most countries. In sectors experiencing rapid growth but an insufficient supply of labour, such as construction and financial services, wage growth has been very marked. This in turn has resulted in rising unit labour costs which, combined with the effects of other rising costs of production, have put significant pressure on firms´ profit margins and ultimately on prices, particularly in sectors with low competition." (Transition Report 2008: 9).

From overheating to crisis

Such extensive growth was not sustainable. Imbalances in the economy deepened. The high deficit in the current account – 15.3 per cent of GDP in 2006 and 16.2 per cent in 2007 – revealed the external imbalance, and the acceleration of inflation reflected the internal imbalance (HCPI reached in 2008 10.6 per cent – see table 4). The imbalance in the labour market was expressed in its transformation into an employee-market.

The expected slowdown in economic growth started. Moreover, the external environment has been considerably less favourable for the Estonian economy since mid-2007. The turmoil in global financial markets (in particular the "examples" of small countries like Iceland and later Hungary and New Zealand) increased the risks of investing in Estonia. The rise of prices on the world market also reached the Estonian economy directly at the end of 2007: in the third quarter of 2008, average import prices were 8.6 per cent higher than in the respective quarter of the previous year. Meanwhile, the press published several articles discussing the devaluation of the Estonian kroon, including one written by the former Governor (1982–93) of the Swedish Riksbank, Bengt Dennis. These articles increased the uncertainty in the economy. In the last quarter of 2007 and in the first quarter of 2008, the GDP fell against the previous quarters on a year-on-year basis. The volume of industrial output began to fall in the second quarter of 2008. Unemployment started

to increase in the fourth quarter, and employment started to decrease in the first quarter of 2009. The development of main cyclical indicators in 2008–2010 is characterised in Table 7.

Table 7: Key indicators of business cycle in 2008–2010

	2008				2009				2010			
	I Q	II Q	III Q	IV Q	I Q	II Q	III Q	IV Q	I Q	II Q	III Q	IV Q
GDP real growth (%)[1]	-2.2	-2.6	-4.5	-10.7	-14.6	-16.6	-15.4	-8.8	-2.6	3.1	5.0	6.6
Volume growth of industrial production (%)[1]	1.2	-2.4	-2.3	-16.4	-23.5	-31.3	-27.3	-12.4	5.7	18.9	24.1	34.6
Number of employed persons (thousands)	657	657	661	653	612	593	598	581	554	559	578	593
Number of unemployed persons (thousands)	29	27	44	54	79	92	102	107	137	128	106	93
Unemployment rate (%)	4.2	4.0	6.2	7.6	11.4	13.5	14.6	15.5	19.8	18.6	15.5	13.6
Number of persons employed in construction (thousands)	82	85	83	75	64	55	59	56	41	41	55	54
Percentage of employed persons in construction (%)	12.4	13.0	12.5	11.4	10.4	9.3	9.9	9.6	7.3	7.4	9.6	9.2
Average monthly gross wages (EUR)	788	850	800	838	776	813	752	783	758	822	759	814
Average monthly gross wages in construction (EUR)	832	889	918	899	747	756	792	770	723	787	816	853
Exports (bn EUR)	2.0	2.2	2.2	2.0	1.5	1.6	1.7	1.7	1.8	2.1	2.3	2.6
Loan portfolio of commercial undertakings with credit institutions (bn EUR)	7.3	7.5	7.6	7.5	7.4	7.3	7.3	7.1	7.1	6.9	6.8	6.6
Loan portfolio of individuals with credit institutions (bn EUR)	7.2	7.5	7.7	7.7	7.6	7.6	7.5	7.5	7.4	7.3	7.3	7.2
Growth of money supply (M2; %)[1]	11.3	9.6	11.5	6.2	3.4	0.2	-0.8	0.8	2.7	5.0	3.0	3.0
HCPI (%; last month of quarter)[1]	11.2	11.5	10.8	7.5	2.5	-0.5	-1.7	-1.9	1.4	3.4	3.8	5.4

[1] On annual basis

Source: Statistics Estonia, Eesti Pank

There were features similar to the so-called debt crisis in South America at the beginning of 1980s, especially in Chile, and also to the Asian crisis of the mid-1990s. Afterwards it was possible to determine that Estonia was one of the first countries in the transition world affected by the crisis (Transition Report 2009: 6). At that time, the question of soft versus hard landing was discussed in Estonia.

In the autumn 2008, a global financial crisis broke out. The flow of foreign capital into Estonia stopped (at the end of 2010, the net foreign liabilities of commercial banks were 1/3 smaller than at the end of 2008). The first “victims” of the crisis were real estate business and construction. But the main setback hit exports. The precipitous decline of demand for Estonia’s main export markets led to a rapid fall of industrial production, 16.4 per cent in the fourth quarter compared to the previous year. The hope of a soft landing disappeared. Moreover, the main export markets of Estonia – Finland, Sweden, Russia, Latvia, Lithuania and Germany – proved to be the biggest losers in Europe. Their share in Estonian exports was 63.4 per cent in 2008 (Table 8).

Table 8: Changes in import demand of Estonia's main trading partners in 2009 and 2010 (per cent; on EUR basis)

	Decrease of import demand of the country in 2009	Decrease of Estonian exports to this country in 2009	Increase in import demand of the country in 2010	Increase in Estonian exports to this country in 2010	As a percentage of total exports of Estonia		
					2008	2009	2010
Finland	-30.0	-22.8	18.0	23.9	18.4	18.5	17.0
Sweden	-24.7	-30.2	29.9	67.7	13.8	12.8	15.6
Russia	-33.9	-31.7	44.0	40.9	10.4	9.3	9.7
Latvia	-37.4	-27.3	25.2	28.5	10.0	9.5	9.0
Germany	-17,5	-7.8	21.2	15.4	5.1	6.1	5.2
Lithuania	-37.9	-35.6	34.5	38.9	5.7	4.8	4.9

Source: National statistics boards

Estonian exports shrunk 23.4 per cent in 2009 and were comparable to the turnover of exports in 2005. The total percentage of the six main export partners decreased by 2.4 percentage points − to 61.0 per cent. The local and global crises fed into each other. The fall of domestic and external demand also led to a rapid decline in employment. In the first quarter of 2010, the number of employed persons (553,600 or 15.7 per cent fewer than in 2008) bottomed out and unemployment peaked (136,900; see table 7). The number of persons employed in manufacturing decreased 21.3 per cent and 50.2 per cent in construction .

The average monthly gross wages and salaries in 2009 was 15.5 per cent lower than in the previous year. Decreasing demand started to press down inflation. Deflationary tendencies in Western Europe also reached Estonia. From May 2009 to February 2010, the inflation rates (HCPI; y-on-y) were negative. On the other hand, the falling import prices and weak internal demand for consumption and investment goods turned the huge current account deficit into a surplus in 2009 and 2010: 4.5 and 3.6 as a percentage of GDP, respectively.

From fall to new growth

At the end of 2009 or beginning of 2010, several European economies began to improve. For Estonia, this signified a recovery of external demand. Estonia's GDP increased again at the end of 2009. After having decreased for nine quarters, GDP turned to growth in annual figures in the second quarter of 2010. The recovery of demand in foreign markets, above all in Nordic markets, was followed by rapid growth of industrial output and exports (Table 7). The number of employed persons started to increase and unemployment decreased. The GDP growth of 6.7 per cent (y-on-y) in the fourth quarter of 2010 was the second-fastest among EU countries after Sweden.

External demand has been the main driver of economic stabilization and new growth. This growth was largely based on the increased utilisation of production capacities. Capacity utilisation in industry in Estonia was only 58.1 per cent in 2009, the second lowest in the Euro zone after Slovak Republic. In the other Euro-countries this figure ranged from 65.4 to 77.4 per cent (excluding Ireland). According to preliminary estimates, the capacity utilisation in industry increased to 73.5 per cent in the first quarter of 2011; nevertheless, this level is one of the lowest in the EU (Deutsche Bundesbank. Monatsbericht 2011, Statistischer Teil: 6–7).

In January 2010, exports started to increase. The total of exports in 2010 was 34.9 per cent higher than in the previous year and also bigger than in 2008. The obvious increase was distinctive for all main directions, especially for exports to Sweden3 and Russia (Table 8).

Nevertheless, the deep recession had several long-lasting consequences on the labour market. Due to increasing productivity and structural changes, unemployment will obviously stay high for a long time, despite the fact that in the first quarter of 2011 the number of unemployed persons was 27.5 per cent lower than in the same period in 2010. The

[3] The rapid increase of exports to Sweden was largely related to extended production of 3G and 4G network equipment and broadband network installations (Ericsson Group).

number of employed persons increased first of all in manufacturing: 22.4 per cent in the first quarter of 2011 (y-on-y). The increase in employment was supported by a possibility of cross-border work, mainly in Finland. In the fourth quarter of 2010, 4 per cent of employed persons worked abroad, including 27 per cent of constructors.

Statistically, the crisis of 2009 was deep. Among the EU countries in the period of 2008–2010, Estonia's amplitude of quarterly growth and fall rates of GDP on year-on-year basis was the highest (Table 9).

Table 9: The amplitude of quarterly growth and fall rates in some European countries in 2008–2010 (y-on-y)

	Highest growth (%)	Deepest fall (%)	Amplitude (percentage points)	Turning to new growth (quarter)	Growth in the fourth quarter of 2010 (%)
Estonia	6.7	-16.6	23.3	II/2010	6.7
Latvia	3.6	-19.1	22.7	III/2010	3.6
Lithuania	7.3	-15.9	23.2	II/2010	4.8
Poland	6.5	(0.6)	5.9	continuous growth	4.1
Czech Republic	3.7	-5.1	8.8	I//2010	3.0
Slovakia	9.5	-5.4	14.9	I/2010	3.5
Hungary	2.3	-8.0	10.3	I/2010	1.9
Slovenia	6.3	-9.6	15.9	II/2010	2.1
Bulgaria	7.2	-7.6	14.8	II/2010	3.1
Romania	9.6	-8.7	18.3	Continuous fall	-0.6
Finland	5.5	-9.9	15.4	II/2010	5.5
Sweden	8.2	-7.1	15.3	I/2010	8.2
Denmark	3.5	-7.4	10.9	II/2010	3.0
Germany	4.3	-6.8	11.1	I/2010	3.8
Ireland	(-0.3)	-9.3	9.0	Continuous fall	-0.7

Source: Eurostat

The recovery is extremely sensitive and vulnerable to global developments, particularly in small and open economies like Estonia, which is heavily dependent on the developments in Finland and Sweden. On the other hand, the introduction of the Euro at the beginning of 2011 and accession to the OECD in 2010 have given Estonia additional advantages. According to preliminary calculations, the annual growth rate of Estonian GDP in the first quarter of 2011 was the highest in EU (8.5 per cent).

Public finance

The cyclical development of the Estonian economy is reflected in public finance changes. The expansive growth of the economy, which was based on an inflow of foreign capital, escalated tax revenue in the budget (Table 10). The creation of new jobs and the rapid growth of wages increased income tax revenue; increases in consumption and investment led to a revenue growth from VAT and excise duties. The tax revenue increased continuously until 2008, including in 2006 and 2007, when the increases were 20.4 and 22.9 per cent respectively. Nevertheless, the income tax rate was reduced from 26 per cent to 21 per cent in 2003–2007. Similarly, public expenditures also increased rapidly. The general government budget in 2001–2007 had a surplus, peaking with 2.4 and 2.5 per cent of GDP in 2006 and 2007. The share of general government consolidated debt from GDP decreased in the same period from 5.7 per cent to 3.7 per cent, which was the lowest among EU countries (Table 11). On the other hand, the accumulation of central government reserves amounted to 1.4 billion Euros, which accounted for 8.6 per cent of the GDP at the end of 2007. In 2008, the general government balance became a deficit: in 2008 and 2009 the deficit was -2.9 and -1.8 per cent, respectively. The deficit was first covered by the reserves. In the middle of 2009, the value of the central government reserves decreased

to 0.8 billion Euros (at the end of 2010, 1.0 billion or 6.9 per cent of GDP). The share of general government consolidated debt in GDP increased to 7.2 per cent in 2009, the main reason being the shrinking of nominal value of GDP.

Table 10: Increase or decrease of revenue and expenditure of general government (per cent)

	2004	2005	2006	2007	2008	2009	2010
Revenue	8.5	14.1	22.6	21.1	2.0	0.9	-3.4
of which							
Taxes	9.8	16.6	20.4	22.9	5.7	-9.9	-1.5
of which							
Personal income tax	7.9	2.3	20.0	25.4	8.0	-22.0	-1.5
Corporate income Tax	17.0	-1.0	25.1	30.8	2.0	-3.8	-24.4
Social security contributions	10.4	15.2	19.9	25.4	14.8	-11.3	-5.4
VAT	1.1	29.8	27.0	19.6	-7.9	-8.5	3.8
Excise duty	26.1	24.4	7.7	16.6	9.5	9.4	6.2
Expenditure	8.4	14.1	19.8	21.0	18.0	-2.5	-7.4

Source: Statistics Estonia

Table 11: Public finance in some European countries in 2007–2010 (as a percentage of GDP)

	Deficit (-) or surplus				General government gross dept			
	2007	2008	2009	2010	2007	2008	2009	2010
Estonia	**2.5**	**-2.8**	**-1.7**	**0.1**[a]	**3.7**	**4.6**	**7.2**	**6.6**
Latvia	-0.3	-4.2	-9.7	-7.7	9.0	19.7	36.7	44.7
Lithuania	-1.0	-3.3	-9.5	-7.1	16.9	15.6	29.5	38.2
Poland	-1.9	-3.7	-7.3	-7.9	45.0	47.1	50.9	55.0
Czech Republic	-0.7	-2.7	-5.9	-4.7	29.0	30.0	35.3	38.5
Slovak Republic	-1.8	-2.1	-8.0	-7.9	29.6	27.8	35.4	41.0
Hungary	-5.0	-3.7	-4.5	-4.2	66.1	72.3	78.4	80.2
Slovenia	-0.1	-1.8	-6.0	-5.6	23.1	21.9	35.2	38.0
Bulgaria	1.1	1.7	-4.7	-3.2	17.2	13.7	14.6	16.2
Romania	-2.6	-5.7	-8.5	-6.4	12.6	13.4	23.6	30.8
Finland	5.2	4.2	-2.6	-2.5	35.2	34.1	43.8	48.4
Sweden	3.6	2.2	-0.7	0.0	40.2	38.8	42.8	39.8
Denmark	4.8	3.2	-2.7	-2.7	27.5	34.5	41.8	43.6
Germany	0.3	0.1	-3.0	-3.3	64.9	66.3	73.5	83.2
Ireland	0.1	-7.3	-14.3	-32.4	25.0	44.4	65.6	96.2

[a] To the surplus led single receipts from the selling of assigned amount units to Kyoto Protocol.
Source: Eurostat

Conclusions

The "OCED Economic Surveys: Estonia" comments on the last business cycle in the Estonian economy with the following words: "The Estonian economy went through an extreme cycle of record-breaking growth up to 2007 and a precipitous decline in 2008 and 2009" (OECD 2011: 9). This is correct. The amplitude of quarterly fall and growth rates

of GDP (y-on-y) in Estonia during the period 2008–2010 was the highest among EU countries. However, the very sharp decline did not mean a collapse. The peak in 2006 and 2007 did not reflect the real situation in the economy. The peak of the cycle was, in essence, the unique time of private consumption and investments based singularly on the excessive inflow of foreign money.

On the other hand, this verified the thesis that the peaks and bottoms of the cycles may be sharper and that entering and exiting from the crises may be faster under the currency board arrangement compared to classical monetary policy.

The contraction of public expenditure helped prevent the fall into the debt trap. The ad hoc rise of the VAT rate from 18 to 20 per cent in the peak of the crisis (1 July 2009) was non-traditional, but at this moment it appears to have been the right decision. Estonia fulfilled the Maastricht deficit criteria in the peak year of crisis also. Inflation was pressed down by import of deflation tendencies and by giving up traditional Keynesian deficit spending policy. Since 1 January 2011, Estonia is the 17th member of the European Monetary Union.

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Estonia's recent Developments in the European Union

Introduction

There is often regularity in economic life: the economy rises and falls, economic recessions are followed by upswings. In order to avoid or limit unexpected negative developments, it is necessary to constantly and comprehensively monitor, analyse, and evaluate the situation in individual countries, regions, and throughout the world. This is particularly true during periods of economic upswing, lest setbacks occur. It is, moreover, particularly important for small national economies that depend on global trends. Euphoria and emotion have no place in any area of the economy. Both were present in Estonia, where the excessive profit orientation of commercial banks led to loan-related problems because of their uncontrolled favouring of both real estate and consumer credit.

The objective of this paper is to give a brief overview of recent economic developments in Estonia, the Estonian government's economic policies regarding the economic crisis, and of the further orientation and problems in the development of the national economy as a European Union member state.

Both the causes and consequences of the economic crisis, which can be delimited with the period 2008–2010 (with the main emphasis on 2009), will need to be analysed more thoroughly and in more detail once the duration of the crisis can be more specifically determined. Regardless, it is necessary to take immediate measures to ensure rational steps with respect to the choice of economic policy and orientations in exiting the economic crisis and in achieving the development. This is topical today for the sake of the future.

This paper is based on different evaluations, the experiences of other countries as they concern Estonia, several research studies in analysing the economic crisis, and the author's own positions. These personal positions are based on official statistics and materials, long-term personal assessments of the economic situation, as well as on years of working with students in seminars of different subjects related to economic policy.

1. General situation of the Estonian economy in 2009-2010

Evaluations of the economic crisis cannot yet be based on specific economic analyses. Although the economy is recovering, the economic crisis is not completely over, and the current situation of Estonia is not yet clear. Has the economy stabilized? Is the recession continuing or has an upswing occurred? These questions remind one of the economic crisis of the 1930s, when the first effective analysis and evaluations were performed years after the end of the crisis (Amin et al. 1982; Berton 1990; Klein 1987; Varga 1974 and many others).

Moreover, the Estonian economy depends on the economic situation of other – larger – countries. Factors of the economic growth, possible crises and the reforms which contribute to exiting from them are necessary for the success. Many economists (such as Krugman, Obstfeld 2006: 780-824) have pointed that out. In Estonia, exiting the crisis does not just mean a return to economic growth, but also an extensive series of administrative, social, educational, and health care reforms, among others.

State and local governments, organizations, companies, and households made many changes during 2009, the first full year of the current economic crisis. They cut costs, restricted activities, and cancelled plans. These were often „efforts to survive." Many companies terminated their activities or went bankrupt. Some individuals declared themselves bankrupt.

The Bank of Estonia has also not taken definite positions and not all necessary possibilities were used to set conditions for the operation of commercial banks. Also, Estonia's liberal economic policy contributed towards the economic crisis.

The most important processes in 2009 were the following:

- state budget expenditures had to be cut1 considerably as revenues remained lower than expected;

- unemployment increased considerably as many companies reduced or terminated their activities;

- economic growth slowed, i.e. the economic recession caused by decreased demand was considerable;

- investments and exports of businesses dramatically decreased (there were no possibilities for exporting their products because other countries also suffered from the economic crisis);

- business development was severely inhibited (while the estimated proportion of profitable entrepreneurs in Estonia is approximately 2% of the labour force, the same estimated proportion in more developed countries is ten or more times higher);

- the products manufactured and the services offered often proved too expensive due to high labour costs (another important reason was low labour productivity);

- local governments got into financial difficulties, often because their obligations were not in conformity with the financing, i.e. they had not been secured with their budget; also numerous cases of corruption were suspected in local governments;

- activities related to real estate were in a significant decline (real estate issues can also largely be regarded as an important trigger of the economic crisis).

The Estonian state budget was cut twice in the course of 2009 through negative supplementary budgets. In the state budget of 2009, revenues was initially established to be 97.8 billion kroons by the Riigikogu, while expenditures (taking into account also the additional cost cutting planned) were 96.7 billion kroons (Riigieelarve 2009). After the first negative supplementary budget of 2009, revenues were planned to be 88.2 billion kroons (reduction of -9.6 billion kroons) while expenditures were expected at 91.9 billion kroons (a reduction of -4.8 billion kroons) (budget of 2009 + supplementary budget of 2010).

The second negative supplementary budget of 2009 reduced revenues by -3.9 billion kroons and expenditures by -2.6 billion kroons. Thus, revenues of the 2009 state budget were 84.3 billion kroons and expenditures 89.3 billion kroons (State 2009 Second Supplementary Budget Act). Planned revenues for the 2010 state budget were 84.5 billion kroons and expenditures were 89.7 billion kroons (2010 State Budget Act). Based on statistics presented by Statistics Estonia and the Bank of Estonia, many economic indicators declined considerably in 2009. For instance, GDP declined by 14.1% in 2009 compared to 2008, industrial production decreased by 26.1%, and the volume of construction works decreased by 34.2%. The number of new cars decreased by 55.6% compared to 2008 (and by 70.9% compared to 2007). The unemployment rate was 13.8% in 2009. The role of tourism decreased: the number of foreign tourists decreased by 6.5% in 2009 compared to 2008 (and by 51.6% compared to 2007). Moreover, the number of Estonians who took foreign trips in 2009 decreased by 28.8% compared to 2008. Capital investments of businesses located in Estonia decreased by 27.6% in 2009 compared to earlier years. (Eesti majandusnäitajad … 2010; Enim … 2010 a,b)

Based on these statistics, as well as factors such as unemployment, decline of salaries, decrease in demand, and budget cuts, we can state the following about Estonia:

- the added value created in manufacturing and in other sectors of the national economy decreased as businesses got fewer orders;

- construction projects decreased as the demand for new living (and office) space had decreased;

- as incomes decreased, the pressure on repayments of bank loans increased; also, the possibilities for and interest in buying new cars and durable goods and in travelling decreased;

- the sales of consumer goods and food products decreased as people bought less, chose more carefully, and bought cheaper goods;

- competition led to the reduction of prices of certain goods and services; sales and discounts were used in trade and services (incl. in food products, consumer goods and construction materials, hotels, restaurants, etc.);

- businesses were not able to make the required investments, therefore product development and innovation suffered;

[1] If we compare, for instance, the Estonian state budget that was initially passed for 2009 and the state budget after passing the negative supplementary budgets, we can see that revenues decreased by 13.8% and expenditures by 7.7% (calculations by the author). Thus, the state budget of 2009 was negative as the higher amount of expenditures was largely covered from reserves.

- *as a consequence of reduced resources of businesses, both their import and export volumes declined.*

Considering comparisons with 2007, it appears that a considerable economic downturn was already evident in 2008. The Estonian government, however, did not take it seriously.

No information has been presented on the increase in labour productivity or its comparison with the increase in the average salary level. Thus we were in a situation, which unfortunately continues, in which the increase in incomes is the primary objective rather than achieving higher quality, more productive and more competitive work, products and services.

Registered unemployment went above 90 thousand people in the first months of 2010 and there were an additional 20–25% of people who had not been registered. Based on that situation, more than 1/5 of the Estonian population capable of work was unemployed.2 Persisting high unemployment levels constitute a risk for the society as social tensions increase, leading to higher crime rates, migration, etc. At the end of March 2011, the number of registered unemployed people in Estonia was 65,831, i.e. 10.2% of the labour force. (Registreeritud … 2011)

The activities of Estonian economic policy institutions (above all the decision-making institutions) before and during the economic crisis were often characterised by untimely decisions and constant delays.

Sometimes, however, delays were followed by rash decisions. For example, the decision to immediately raise the VAT rate in mid-June 2009 on most goods and services from 18% to 20%. Probably both the government and politicians lacked the proper will in economic policy, an adequate evaluation of the situation, and clear objectives. At the beginning of the economic crisis, they were not able to evaluate the situation adequately or respond to it in due time.

2. Attempts to stabilize the Estonian economy and expected trends

In 2009–2010, different measures were taken in an attempt to stabilize the Estonian economy. Some of the most important of these were:

- *The Employment Contracts Act came into force on 1 July 2009, intended to proceed from the principle of flexicurity for both employees and employers3 ;*

- *The VAT rate for most goods and services was raised from 18% to 20% on 1 July 2009; the reduced VAT rate was raised to 9% and is now applicable to books, workbooks, newspapers and journals, medicinal products, and accommodation services;*

- *Income tax rates for both individuals and legal entities remained at the 2009 level of 21% during 2010 despite the fact that an annual reduction of the income tax rate by 1% had been planned before the crisis;*

- *Excise tax rates for motor fuel, alcohol, tobacco products were raised on 1 January 2010, and for electricity on 1 March 2010;*

- *The payment of the land tax became more tense: there were now two deadlines for 2010 – 31 March and 31 October – while there had previously been three deadlines – 15 April, 15 July, and 15 October;*

- *A patient contribution of 15% for rehabilitation treatment came into force on 1 January 2010, while this had previously been financed by the Sick Fund.*

The Estonian Strategy for Competitiveness for 2009–2014 was adopted to achieve greater national economic growth and higher employment levels. The following objectives were set as priorities for the next few years according to the strategy (Uuendatud ... , 2010: 29):

- *implementation of a conservative macroeconomic policy, which will make it possible to:*

    - keep the government budget deficit below 3% of the GDP;

    - join the euro zone in 2011;

    - keep the increase in public debt under control;

    - preserve Estonia’s ability to make investments in the next few years

[2] In 2010 the employment rate of 15–74-year-olds was 57.4% in Estonia. The highest employment rate in the period 1995–2009 had been in 2008, namely 63.0% (Eesti majandusnäitajad ... 2010).

[3] Until then, the opportunities and positions of employers seemed to be better than those of the employees.

- *improvement of the exporting capacity of businesses, which:*
    - supports the creation of the favourable environment for the improvement of productivity;
    - retains export volumes at the 2008 level;
    - increases the attractiveness of Estonia for foreign investments;
- *development of employee skills by*
    - increasing the financing of life-long studies;
    - focusing on further training and retraining;
    - making use of the low level of employment by improving the skills level of 50,000 people by one stage
- *maintaining the employment level by*
    - developing the business environment;
    - increasing the volume of public investments;
    - supporting the retention of jobs in order to restore the earlier general 63.5% level of employment by 2011.

Joining the euro zone is thus no life jacket for the development of the Estonian economy, but rather a tool among many for the implementation of a rational economic policy.

3. Activities for alleviating and exiting the economic crisis

Emergence from the economic crisis requires purposeful and effective actions and the adoption of economic policy decisions.. The structure of the national economy will certainly not be the same after the economic crisis. There will be important shifts, both in the proportions and content of different economic sectors and in the branches of the economy. This will assume a comprehensive and intensive retraining of labour all over the country, which the state should coordinate and encourage through its institutions. Until now the state has been quite half-hearted in its activities. It is appropriate to emphasise here that the public sector has not sufficiently cut its expenditures or raised the efficiency of its activities. The current cuts of expenditures have not led to rational activities of the state. Although there have been some salary cuts and several government agencies and institutions have been merged, it is now necessary for officials to take comprehensive measures that would be more effective in all respects; moreover, until now the activities of several agencies have often been overlapping.

Foreign experts from well-known economic newspapers and journals, international central banks, and foundations have made different forecasts concerning the Estonian economy. These forecasts have been both positive and negative. At the same time, we can generally state: such positions are interesting, sometimes even necessary, but one should not take them very seriously as such evaluations usually contain subjective and sometimes misleading conclusions. Such experts do not have sufficient information about Estonia and do not know the actual situation and conditions in Estonia. It is not possible to make adequate evaluations based on single statistics. It is also necessary to know the background and the factors influencing it. In order to exit the economic crisis, Estonia has had to focus attention on the following:

- *Favouring the development of production activities, including manufacturing. This area has not received sufficient attention in Estonia until now. It has often been thought that intermediation, transit, tourism, real estate activities, IT development, etc. would be sufficient. These are important areas of development, but real economic growth can only be achieved by creating manufacturing jobs, including making efforts to develop national industries;*

- *Improving labour productivity on all levels (this assumes also the use of modern engineering and technology, access to information, etc.). It is important to monitor constantly the ratio between the growth of productivity and the increase in salaries.4 Also, the creation of a favourable investment climate is important;*

- *Improvement of the economic and business environment and favouring their functioning in all respects;*

- *Favouring long-term investments in municipalities (including lending support for significant projects);*

[4] The ratio between the growth of productivity and the increase in salaries is not taken into account in Estonian economic policy making. At the same time, it is important to bear in mind that the growth of productivity is faster than the increase in salaries. Statistics Estonia has not paid sufficient attention to the labour productivity indicator either. Also, the General Director of Statistics Estonia supports the need for constant calculation and publishing/monitoring of the above-mentioned indicators (Potisepp 2010).

- More specific definition of the functions of the state and municipal levels in order to better divide the financing between the two entities;

- Improved use of the EU funds.

These orientations can be better implemented if the need for balanced regional development and also for the conduction of the administrative-territorial reform are taken into account. Regional development in Estonia is extremely unstable, confirmed by regional comparisons of almost all Estonian economic indicators).

4. Economic crisis, general economic situation, unemployment, and increase in prices

The economic crisis had a deep impact on the Estonian economy and brought along a recession (see Table 1). The unemployment rate in 2010 was at an unprecedented high level of 16.9% (Enim … 2011). The official maximum unemployment rate reached 19.8% in the first quarter of 2010 (Kiire … 2011). This unemployed rate is unacceptably high in Estonia; according to different evaluations, there were approximately 120–130 thousand unemployed people in Estonia in 2009–20105, or approximately 20% of the Estonian labour force. In addition, a large proportion of the population has not been recorded as unemployed (i.e. if a person has not started work within one year, then he or she is taken off the register of unemployed people; also, a large number of people have never registered themselves as unemployed, although have been without a job for years). Such a situation is not a positive characterisation of the economic policy of the country. When László Andor, the EU Commissioner for Employment, Social Affairs, and Inclusion met with journalists in Brussels on 11 March 2011, he directed attention to Estonia and Spain as countries with a high unemployment level. Among other things, he said: „high unemployment level refers to the failure of the economic policy of the government“ (Kõrge … 2011). We probably have to agree with that.

The extremely high unemployment level referred to the poor labour market policy of the state. It also referred to the fact that

- first, not all unemployed people are interested in returning to work or able to acquire retraining

- second, the business communities are not certain about their need for employees (with which specialities and which qualification and how many employees are required anywhere; also separately for highly qualified employees and engineers)

- third, employers have no clear interest in paying the costs of retraining and raising the qualification of their employees

- fourth, local businesses have relatively little, if any, interest in making investments (which would provide an increase in labour productivity in the long term); at the same time, businesses are often very profit-oriented.

In September 2010, the Bank of Estonia mentioned in its economic policy statement (Toormehindade ... 2010):

- The Estonian economy has overcome the recession and started to grow above all with the support of exports

- The Estonian businesses and the state have raised the efficiency of their activities

- During the second half of 2010, unemployment will decrease in Estonia but long-term unemployment will increase in 2011

- The decrease in salary levels and prices due to the economic crisis has proven to be short-term and lower than could have been assumed from the extent of decrease in GDP.

This were relatively optimistic evaluations. In-depth analysis of the situation, however, may not always provide such hopeful results.

Table 1: Main indicators (2007–2009) and forecasts of their changes (2010–2012) in Estonia compared to the previous year

Indicators	2007	2008	2009	2010	2011	2012
GDP (bill. euros)	15.8	16.1	13.9	0.5	0.8	1.1
GDP change in constant prices (%)	6.9	-5.1	-13.9	1.5	0.1	0.5
Inflation of harmonised consumer prices (%)	6.7	10.6	0.2	1.2	1.6	0.4
Change in private consumption in constant prices (%)	8.6	-5.6	-18.8	4.7	5.1	0.5

[5] The number of people capable for work at the age of 15–74 years was 686.9 thousand in Estonia in 2010 according to Statistics Estonia.

Change in investments in constant prices (%)	6.0	-15.0	-33.0	-9.0	6.3	-0.5
Change in exports in constant prices (%)	1.5	0.4	-18.7	6.5	-1.7	0.1
Change in imports in constant prices (%)	7.8	-7.0	-32.6	11.7	1.4	-2.9
Unemployment (%)	4.7	5.5	13.8	1.8	0.3	0.2
Change in employment (%)	1.4	0.2	-9.2	-2.3	1.8	-0.4
GDP change per employee in constant prices (%)	5.4	-5.2	-5.1	4.1	-1.7	0.9
Change in average gross salary (%)	20.4	13.8	-4.6	4.4	1.8	0.1
Change in loans volume at the end of the period (%)	30.2	7.3	-6.4	-1.3	-1.4	-2.4
Gross foreign debt (% of GDP)	109.8	118.2	125.5	-4.2	-8.5	-13.3
Budget balance (% of GDP)	2.6	-2.8	-1.7	1.1	1.1	0.5

Source: Statistics Estonia, Eurostat, Bank of Estonia

The respective Maastricht criteria had to be fulfilled by 2010 in order for Estonia to adopt the euro on 1 January 2011. Meanwhile, the authorities consistently told the general public throughout 2010 that the euro would not raise the prices. Indeed, it was not the euro that led to the rise of prices in Estonia. Rather, entrepreneurs and traders opportunistically increased prices. This began as early as May 2010, and the higher prices were already in place on 1 January 2011 so that they could remain on the same level. Prices, however, continued to rise in January–February 2011 (see also Table 2 below), and will continue to do so in the future (referring above all to global price increases in the market, etc).

The change in the consumer price index in March 2011 in Estonia compared to March 2010 was 5.2% and 0.8% compared to February 2011. The price of goods increased by 7.0% and the services 2.1% compared to March 2010. Regulated prices of goods and services increased by 6.3% and unregulated prices by 4.8% compared to March 2010. The index was most influenced by the 11% price increase of food products, which accounted for approximately one half of the total increase. Approximately one half of this consisted in the 18% price increase of dairy products and 12% price increase of milled products compared to the period of the previous year. Also, the 14.2% price increase of motor fuel had an important effect. Compared to the same time in 2010, largest price increases were for potatoes (84%), coffee (48%), and apples (40%). Also, the prices of fuel oil (32%), cereals (31.6%) and milk (31%) have increased more than 30%. (Tarbijahinna-indeks … 2011) The impact of the world market prices on the price increase of food products, which is much discussed in Estonia, is not certain because:

- *No respective economic analyses have been performed in Estonia nor any facts presented.*

- *Observations and price comparisons of the author of this paper when staying in the Federal Republic of Germany in November and December demonstrated that while food prices increased in Estonia, they did not increase in Germany (there were massive and extensive price reductions in Germany instead during the period before Christmas); the shopping basket of the author was 20–25% cheaper in Germany than when living in Estonia.*

- *This raises the issue – did not the prices of the world market have any effect on food prices in Germany?*

- *There are also doubts about the seriousness of the campaign agreements started in the middle of 2010 in Estonia, which were extensively advertised as the agreement between traders and other businesses not to increase prices during the period before the adoption of euro; this was loudly announced to the general public (according to the observations of the author of this paper in the Estonian supermarkets in September–October, the prices were increased after all despite promises, sometimes even by 20–30%!).*

It is appropriate to present the information of the Bank of Estonia here: „Inflation rates of the main trade partners for Estonia has also recently increased. Prices of Estonian food products depend on developments in the markets of our foreign trade partners and have therefore considerably increased within the last year. The Estonian food processing industry has reaped high profits from the price increases, which were the highest ever in the fourth quarter of 2010. These are even 1/6 higher than in the previous highest level achieved in 2008. … High variations of mark-ups (M.R. – greediness of traders) is also felt in consumer prices of food products and therefore the inflation in Estonia has been much more hectic than in other countries. … At the same time, the foreign factors cannot be blamed for the increase in retail mark-ups which rose to record-breaking levels again in 2010." (Lindpere 2011)

Public figures, including representatives of several trade associations, have probably often been demagogic in Estonia in their statements about producers and traders not raising prices, and businesses, including traders, have been opportunistic.

5. Adoption of euro and price dynamics in Estonia

The transition to the euro has often been regarded as an important objective for enlivening the economy and achieving economic growth. In fact, it is rather a tool of monetary policy, which will not show its actual impact until a few years from now. Regardless, transition to the euro was related to many activities in Estonia: budget cuts, fulfilment of the criteria for the adoption of euro; alleviation of the economic crisis, and exiting from the crisis.

The current evaluation is based on the following question: was the adoption of euro at such a price for the Estonian national economy – high unemployment rate, extremely low quality of life of many people, and many other social problems – a timely step (or maybe too hasty) to ensure the development of the small country? Perhaps party politics played a greater role than stable welfare growth of the population, improvement of the quality of life of people, and achievement of economic development.

It is interesting to look at the results of the households budget survey in Estonia, conducted by statistics organisations of all EU countries according to a harmonised methodology.6 A household member spent less in Estonia in 2010 than in 2007, but the proportion of compulsory expenses, i.e. inevitable housing and food expenses, increased in the household budget. According to the households budget survey, each household member spent on an average of 265 euros (4,139 kroons) per month in 2010, including 45% (119 euros) on compulsory food and housing expenses. The proportion of compulsory spending has increased in the household budgets in the recent years. According to the last comparable survey of 2007, a household member spent 278 euros (4,358 kroons) per month, including 40% (108 euros) on compulsory expenses. The increase in the proportion of compulsory expenses in the budget shows a lower quality of life as less money and opportunities are left for other expenses. (Sundkulutuste … 2011)

In 2010, a household member's greatest expense was for food (69 euros per month), which accounted for 26% of total expenses. Fifty euros per month were spent on housing, 29 euros on transport, 25 euros on spare time, 16 euros on household expenses, 12 euros on clothes and footwear, and 10 euros on health care per household member. Compared to 2007, housing expenses have increased by approximately a quarter. Moreover, expenses related to spare time have somewhat increased. Expenses related to clothes and footwear have decreased most of all, by more than a third. Also, expenses for transport and eating out have decreased. (Ibid.)

Price increases in Estonia during the transition to the euro are characterised by some examples highlighted in Table 2. The increase in the price of raw materials in the world market partly drove the price increases, but the opportunism of businesses and traders also played a role.

The purchase price of milk was 23% higher in Estonia in January 2011 than it had been the previous year (and the price has increased 29% compared to January 2009). The purchase price of wheat has increased 112% in 2011 compared to 2010, with a price increase of 84% compared to the price in 2009. The purchase price of pork increased 1.4% during one year. Compared to February 2010, dairy products, bread, potatoes and vegetables have become considerably more expensive for consumers. For instance, the price of milk was up 46.9%, sour cream 32.7%, coffee cream 29.9%, cheese 20.4%, kefir 18.2% and butter 12.9%. The prices of pork and pork products decreased in the course of 2010, but the prices of beef, chicken and minced meat, and frankfurters increased. The prices of white bread products in shops increased 15.8% and black bread prices increased 7.5%. The prices of fresh vegetables increased in shops, including head cabbage 226.3%, imported tomatoes 17.8%, carrots 17.5% and fresh cucumbers 1.4%. The price of unpacked

[6] The evaluations are based on the results of Statistics Estonia's households budget survey of 2010. The last comparable information is from 2007, as no surveys were conducted during the years in between. In 2010, more than 3,600 households participated in the survey. A household is a group of persons living at the same address and using money in common, whose members regard themselves as belonging to the same household. A household is different from a family that is based on blood relationship or relationship by marriage. In 2010, there were approximately 600,000 households in Estonia, the average size of a household was 2.3 persons. (Sundkulutuste … 2011)

potatoes increased 112.7% during the year. The price of eggs decreased 5.6% during the year. The average retail price of motor fuel (95E) in automatic gas stations was 1.20 euros/litre in February, which was 12% higher than a year ago. Diesel fuel prices increased 18% during the year. (Toidukaupade … 2011) This is another example of the actual price increases.

Table 2: Dynamics of certain prices in Estonia in 2010–2011, before and during the adoption of euro

Order No.	**Goods / services**	**Price in December 2010** (EUR)	**Price in February 2011** (EUR)	**Price increase** (%)
1.	Rakvere frankfurters, 1 kg	2.70	3.61	34
2.	Main course of pork chop	5.00	8.95	79
3.	Solyanka soup	1.92	2.50	30
4.	Fresh tomato, 1 kg	1.50	2.00	33
5.	Fresh cucumber, 1 kg	2.27	2.99	32
6.	Carrots, 1 kg	0.26	0.38	46
7.	White head cabbage, 1 kg	0.46	0.65	41
8.	Bananas, 1 kg	1.25	1.69	35
9.	Pasta	0.95	1.25	32
10.	Potato (unwashed), 1 kg	0.33	0.60	82
11.	Vegetable oil (from rapeseed), 1 litre	1.91	2.59	36
12.	Sugar, 1 kg	1.02	1.19	17
13.	Light beer, 4.5%	2.24	2.50	12
14.	Palmolive soap	0.30	0.44	47
15.	Haircut (ladies)	8.50	12.20	44

Source: Pealinn 2011: 4-6

The Consumer Protection Board also notes that businesses have continued to adjust their prices after the transition to the euro by making the prices more attractive for marketing. For instance, in January 2011, a little more than 10% of prices ended with the number 9, but in March 2011 there were already more than 20% of such prices (Eesti toiduainetööstus … 2011). These adjustments have also led to a certain increase in prices.

The prices of food, services, and several other products will combine with the price dynamics to gradually shape the attitude of the population towards the euro in Estonia. Concerning the attitude towards the euro, it is, for instance, generally known that Germans were not as enthusiastic about the euro as they were about the German mark. The strength and stability of the mark had been ensured by (Kaupmees 2010):

- *the general knowledge that hard work and diligence led to success*
- *discipline and order in everything, including in one's work*
- *extensive saving and economizing*
- *a high level of engineering*
- *high economic productivity (achieved through all the above-mentioned factors).*

Probably many countries, including Estonia, need to follow the example of Germany in many issues. The economic growth forecasts for Germany have been optimistic. For instance, in November 2010 the economic growth forecast for 2010 in the European Union was 1.8% and in Germany 3.7%. For 2011, the respective forecasts were 1.7% and 2.2% (Tageschau 2010). Germany has also been regarded as the so-called engine of the European Union for exiting the economic crisis (Ibid). For instance, in November 2010 the consumer price index increased by 1.5% in Germany, above all due to the price increases of food products and motor fuel (Regional 2010). At the same time, the price comparisons show that the price increases of goods and services in Estonia are almost double the average increases in the EU (Pao 2011: 8). When we compare the prices of February 2011 with those in February 2010, however, the change in the consumer price index in Estonia was 5.7% (Enim … 2011). Considering the economic situation in Germany and the situation of the euro zone, it is evident that the leadership and economy of Germany is necessary to stabilize the euro.

Unlike in Estonia, the prevalent basic economic position in Germany has been that the increase in labour productivity has to exceed the increase in average salaries. According to Statistics Estonia, the Estonian economy and the Government of the Republic of Estonia are not particularly interested in these indicators. In other words, there is no

demand. Thus, the increase in average salary has outpaced the increase in labour productivity in Estonia since regaining independence twenty years ago. Economists have ignored the non-observance of that ratio (particularly in the years of high economic growth). The Estonian media has mentioned it, but only in the context of the economic crisis. The actions of the government in Estonia quite often reminds us of the Soviet days, when suitable economic indicators were carefully selected to characterise the positive developments of the country.

Conclusion

The creation of many new private companies (above all micro businesses and small businesses) supported the rapid economic growth of Estonia in earlier years. Other factors included active investment activities (including involvement of foreign investors), the expansion of economic contacts, and reforms in the areas of education, agriculture, health care, among others. Joining the European Union and NATO have also contributed to the development of Estonia. However, several wrong or half-hearted decisions limited productivity in Estonia.

The economic crisis had an extensive impact on Estonia. It led to decreases in exports, demand, production, the redundancy of labour, and a reduction of salaries. Bankruptcies of companies also profligated, leading to a dramatic increase in unemployment, an increase in regional imbalance, and many other phenomena. The problems were most evident outside larger cities, particularly in the Estonian rural areas. Exiting the economic crisis largely depends on the success of other EU countries and countries throughout the world in overcoming difficulties.

The adoption of the euro in Estonia on 1 January 2011 (which is often officially regarded as an important objective for the achievement of recovery and growth of the economy) was an instrument of monetary policy, but the actual impact of the currency will not become evident for at least a few years. Fulfilling the criteria for the adoption of the euro, the related budget cuts, and operating in the situation of the economic crisis have taken the Estonian economy to a difficult situation. The economic crisis and the objective of adoption of the euro have been a double burden on the Estonian society and economy, especially in 2009-2010.

The extremely high unemployment rate will surely remain for a long time. Although unemployment decreased in the second half of 2010 and economic growth increased, many unemployed people are either not interested in getting a job again or are able to learn and acquire retraining. Moreover, employers have no clear idea about the labour they need, nor do they have a clear interest in incurring the expenses of retraining and further training themselves. Neither employers nor owners have particular interest in making investments to update outdated equipment.

The central question is whether the adoption of the euro at such a price – high unemployment rates, extremely low quality of life of many families, additional social problems – was a timely step to ensure long-term stable development of the small country. Were the interests of party politics in the foreground rather than the well-being of the population and the achievement of balanced economic development?

There are numerous additional activities, many of which are interrelated. These include: the reduction of the number of the unemployed through job creation and the founding of new businesses, despite the lack of qualified labour; economic restructuring towards science-intensive activities; and the achievement of a higher rate of productivity. Development of national production activities and industry, rather than relying on subcontracts and foreign investments, is necessary, .The quick completion of administrative and territorial reform soon (it has continued for more than ten years already) is also important, as is achieving balanced regional development. It is also necessary to complete the land reform to enable private owners (rather than merely agricultural producers) to cultivate and manage the land. Other necessary reforms include tax reform, which is necessary to achieve social justice, and educational reform, which would lead to higher quality. Finally, the further and closer cooperation of the three Baltic states – Estonia, Latvia, Lithuania – should be regarded as important. In short, Estonia needs to develop from a society of officials into a society of citizens.

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Changes in Lithuanian labour market during period of economic recession

1. SOCIO-ECONOMIC CONSEQUENCES OF THE ECONOMIC RECESSION

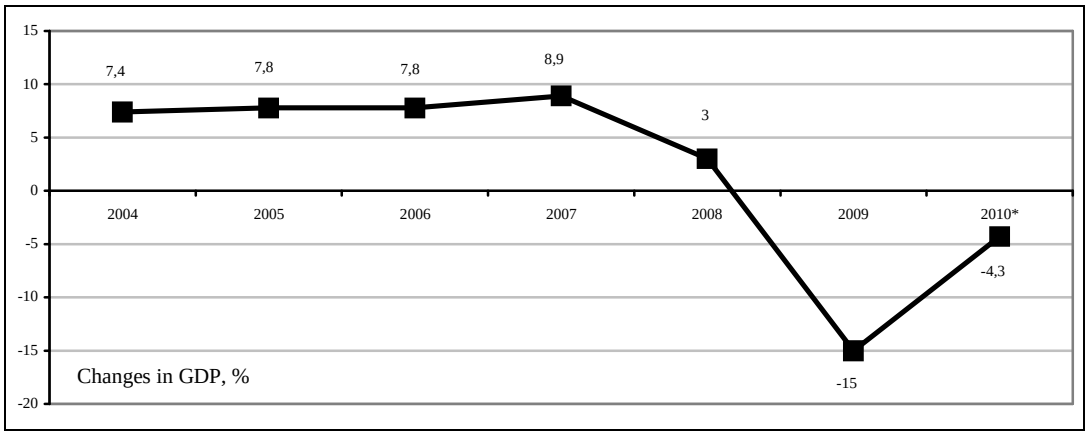
Recessions have far-reaching impacts on a range of economic and social outcomes. Rapid falls in exchange rates are often viewed as the key indicators of a recession and subsequent GDP contractions (Baldacci et al, 2002). Economic crises that usually occur as the result of sudden, unanticipated shocks (e.g. the shock that arises from large capital outflows) lead to a sharp decline in output, and often to substantial price increases (Prennushi et al., 1999; Sumner et al., 2009).

Economic downturn affects labour markets and the behaviour of individuals in employment. The most important consequences of the recession towards labour markets are reduced demand for labour, and thus lower employment, reduced wages, and lower labour income (Prennushi et al., 1999; Sumner et al., 2009; Knowles et al, 1999).

Studies also show that economic recession causes a reduction in the labour force employed by both the private and public sectors. The falling labour demand has a depressing effect on formal sector wage rates. Crises are generally accompanied by increased health risks and decreased affordability of health care (Gruževskis, Zabarauskaitė, 2010 by Knowles et al, 1999). Furthermore, evidence suggests that recessionary periods have detrimental effects on social indicators that are greater than the gains during equivalent periods of growth (Gruževskis, Zabarauskaitė, 2010 by Edstrom, 1999). Despite of the first signs of economic recovery, Lithuania is still experiencing its deepest recession since regaining independence. When the economy slowed down, sales and production in most economic sectors declined, and unemployment increased simultaneously. Financial crisis triggered inflation, unemployment, drop in purchasing power, and the growth of public debt (the government may have to devalue the national currency or borrow from the International Monetary Fund) and others (Račickas, Vasiliauskaitė, 2010).

The Lithuanian economy from 2004 to 2007 was one of the fastest growing in the EU. In 2007, the national economy grew at a rate of 9.8 percent. Since 2004, GDP growth has been impressive: average annual growth reached 7.6 percent. The main factors of this economic development were rapid household consumption and investment growth. Increase in employment and labour shortages led to wage growth. In 2008, Lithuanian economic growth began to slow rapidly, falling to 2.8 percent. A decrease in domestic demand was one of the main causes of this decline. The deepening global financial crisis and weakening external demand furthered the Lithuanian economic downturn. In 2009, GDP growth was negative and amounted to -15 percent.

Figure 1. Lithuanian GDP growth dynamics in 2004-2010

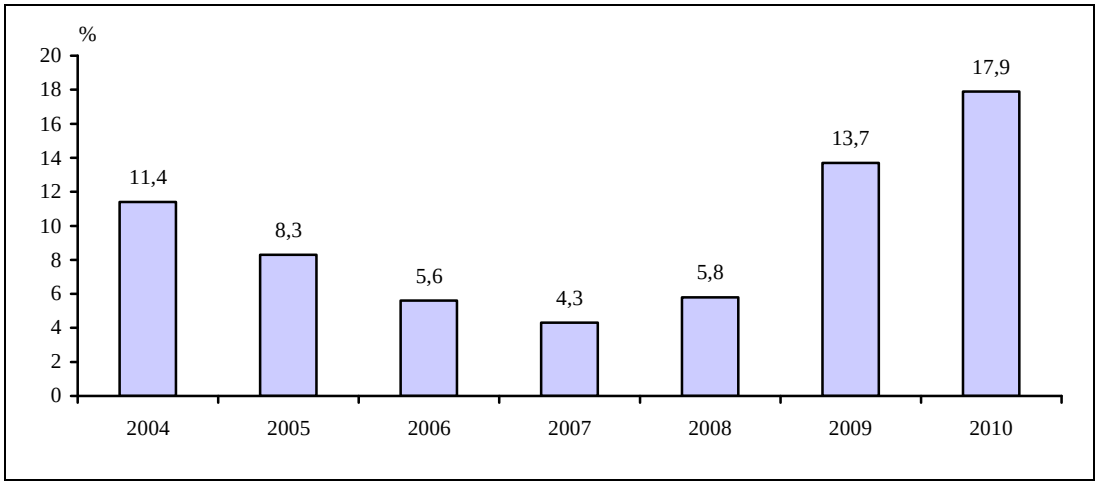


Source: Lithuanian Economic Survey 2009/2010.

A significant increase in the unemployment rate was observed in the country since the end of 2008. According to the data of Department of Statistics, the average unemployment rate in Lithuania in 2009 was 13.7 per cent. In comparison

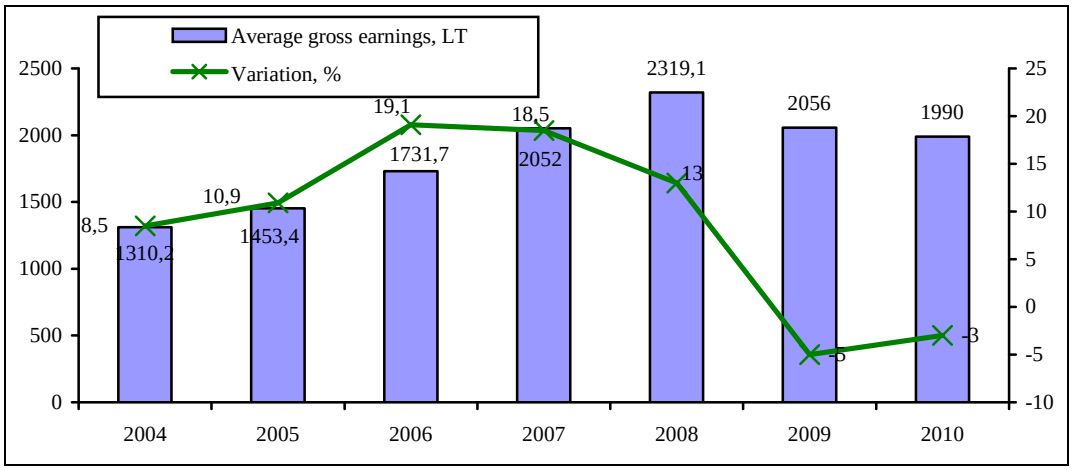
with 2008, unemployment more than doubled.. National Labour Force Survey data showed that the unemployment rate was 18.1 per cent in the first quarter of 2010.

Figure 2. Average unemployment rate in Lithuania, 2004-2010 (per cent)



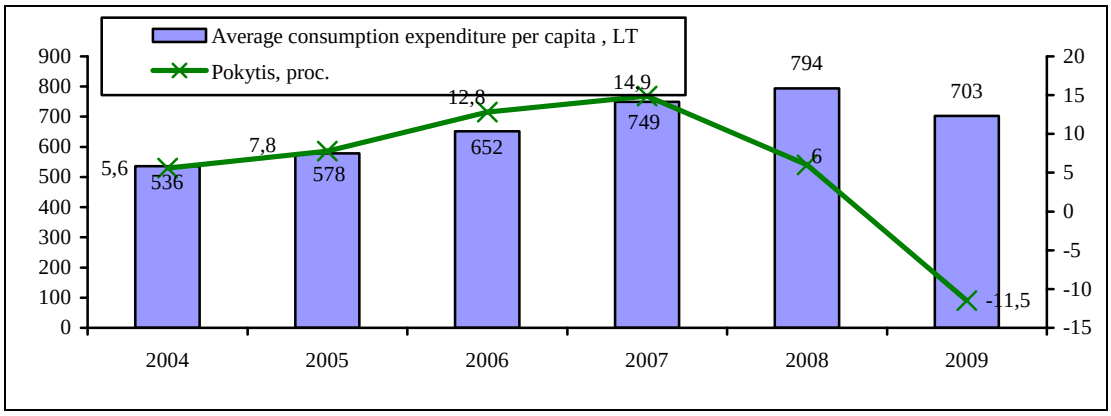
Statistics Lithuania shows that in 2009 the average gross earnings (including individual enterprises) in the country amounted to 2,056 litas (or about 596 Euro) per month, 5 percent less than in 2008. In 2010, the average gross earnings amounted to 1,990 litas (almost 577 Euro), or 3 per cent less than in 2009.

Figure 3. Average gross wage (in litas) in Lithuania (with the exception of individual enterprises) 2004-2010 (percent)



The consumption expenditure that had steadily increased during 2004-2008 decreased in 2009. According to the Statistics Lithuania, household consumption expenditure at current prices during the first quarter of 2010 was 12 percent lower than in 2009 Q I-III.

Figure 4. Average consumption expenditure per capita per month, 2004-2010 (Lt and annual change)



The significant economic recession in Lithuanian that was caused by the real estate crisis, precarious bank lending policies, and ineffective political decisions rapidly destroyed the achievements of previous economic development. Moreover, the global financial crisis had a stronger effect on the Baltic states than elsewhere in the EU. According to estimations of experts, the current economic recession in Lithuania is more severe and will last longer than in 1999 (Nausėda, Tauraitė, 2009).

The economic downturn created a big budget deficit in 2008-2010. In 2008, Lithuania's budget deficit reached 3.2 percent of GDP, and in 2009 - 9.5 percent. Compared with 2008, Lithuanian state budget revenues in 2009 declined 10.8 percent while expenditures remained the same.

Table 1. Lithuanian state budget revenue, expenditure, and deficit in 2004-2009 (bln. Litas)

State budget items	2004	2005	2006	2007	2008	2009	Change in % 2009 compared with 2008
State budget revenue	11.8	14.1	16.8	20.7	23.2	20.7	-10.8
State budget spending	12.7	14.8	18	21	24.6	24.6	0.0
Budget deficit	-0.9	-0.7	-1.2	-0.3	-1.4	-3.9	178.6

The results of the empirical research of the shadow economy in Lithuania carried out by Krumplytė (2010) show that in 2006-2009 officially unaccounted revenue, due to the shadow economy, was between 15 percent and 38.5 percent of all received revenue. Social consequences of economic recession. Economic recession had devastating effects on a range of social conditions. As indicated in the literature, many of the declines have persistent or irreversible effects – costs that last for years after the financial consequences of a crisis have been mitigated (e.g. workers who lose their jobs for a year or more during a recession may find it hard to return to formal employment) (Edstrom, 1999; Cecchetti, 2009).

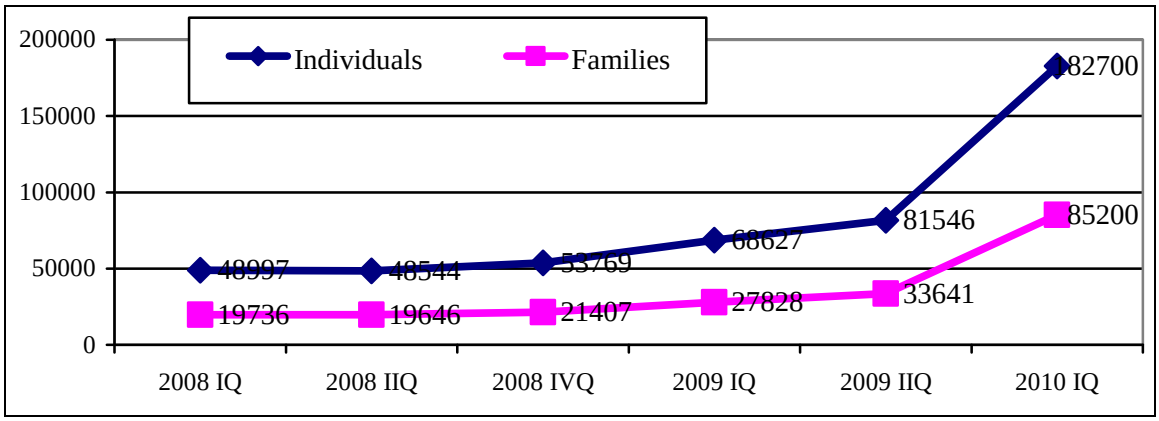
Earlier research shows that the incidence and severity of income poverty usually rise during a crisis, frequently in combination with pressures on other dimensions of well-being. These include nutritional status, education, health, and security. While these changes may affect people in all strata of life, they can have a particularly devastating impact on those living below or close to the poverty line (Edstrom, 1999; Baldacci et al., 2002).

Baldacci et al. (2002) argue that financial crises impact poverty through several transmission mechanisms. Approximately 60-70 percent of the poverty impacts of a recession are due to four factors: unemployment, inflation, reduced public expenditure, and GDP contraction. According to him, the extent of the poverty rise during the crisis period depends on an aggregate level of changes in GDP and income inequality. At the household level, it depends on household characteristics, education, and location. Some of the poor will be protected by their geographical isolation and poor connectivity with national and global markets (Ravallion, 2008).

Historical evidence presented by Schmitt and Baker (2008) shows that „labour-market recessions last far longer than the technical recessions. Long after financial markets and employers have begun to recover from an economic downturn, workers continue to suffer from high levels of unemployment, depressed levels of employment, falling incomes, loss of health insurance, and outright poverty.“ Income poverty and social exclusion. With Lithuania's rather ineffective unemployment insurance system, an increase in the number of the unemployed is closely linked with increasing poverty in the country (especially as a result of increasing long-term unemployment when no income is earned for more than a year). This fact is clearly revealed by a sharply increasing number of persons receiving social benefits in Lithuania.

The statistical data analysis shows that since the third quarter of 2008, the number of recipients of social benefits has dramatically increased in the country. In the last quarter of 2010, social benefits were drawn by about 215.2 thousand people in Lithuania, i.e. four times more than in the first quarter of 2008. Compared to the first quarter of 2008, the total number of families receiving social benefits in 2010 jumped by more than 430 percent (from 19.7 thousand to 85.2 thousand). Such a sharp growth in the number of recipients of social benefits was conditioned by falling income of the population and particularly by the increased number of job cuts in the recent period1.

Figure 5. Dynamics of the number of recipients of social benefits in Lithuania in 2008 – 2010 (by quarter)



Source: Social map of Lithuania. Available via internet: <http://www.socialiniszemelapis.lt/index.php?22274078>

The data of the Survey on Income and Living Conditions, collected by Statistics Lithuania, indicates that the unemployed are particularly vulnerable in the Lithuanian population. In 2007, the unemployed's at-risk-of-poverty rate was 57 percent, among the highest in the EU. The unemployed were at risk of poverty roughly seven times more often than the employed.

Households where the main source of income is the income derived from work are also at risk of poverty. The income derived from work does not ensure a family member's income level is higher than the poverty line, which is defined as 60 percent of median equalised disposable income. The EU-SILC survey conducted in 2009 shows that the number of such households in Lithuania amounted to 10.4 percent (EU – 8.4 percent). The at-risk-of-poverty rate among the unemployed was 5 times higher than those of the employed and made 54.3 percent.

A comparison of minimum monthly wages (MMW) and the relative poverty line during the subject years helps analyse the problem of in-work poverty. In 2008-2010, the MMW in net terms amounted to LTL 660.8 (about € 191). The at-

[1] Social benefits in Lithuania are paid to a family (single resident) if its average income during the period of three months preceding the month when the family (single resident) applied for a benefit was below the state supported income (SSI) per family (single resident) (i.e. 350 LTL), as well as if the value of the property owned by the family

risk-of-poverty threshold for a single person was LTL 831 (about € 243) (SILC (2009) 2008 income data). The income derived from work of a person living alone and receiving MMW was 21 percent lower than the at-risk-of-poverty threshold. Thus, people living alone who were below the poverty threshold despite having been employed during the working period and received MMW had no opportunity to escape from the risk of poverty. Persons receiving MMW and experiencing risk of poverty may be related when they work full time or have dependants with no income or whose income (from work or social benefits) were lower than the poverty threshold. In addition, a family of four members (with two persons employed and receiving MMW and two dependants) also had no opportunity to avoid the risk of poverty, as their income per one family member was LTL 330,4 (about € 96) and at-risk-of-poverty threshold - LTL 436.5 (about € 127).

The percentage of people working full time and receiving MMW has a tendency to rise among the total number of the employed in Lithuania. The share of those receiving MMW in 2007 constituted 7 percent; in 2008 - 7.2 percent; and in 2009 - 9.7 percent. The European Union Statistics on Income and Living Conditions (EU-SILC) also showed negative changes in the indicator of the households whose main income source was the income derived from work. In 2007, the at-risk-of-poverty rate in these households constituted 9.4 percent, rising to 10.4 percent in 2008. The majority of low-income workers live in rural areas in Lithuania. Around 32.7 percent of the rural population experienced the risk of poverty compared to 14.7 percent of those living in urban areas. Comparing the qualification of the rural and urban labour force, certainly, the qualification of rural population is lower than urban population. On the other hand, the in-work poverty rate in Lithuania does not reveal the real poverty situation because the relative poverty threshold in Lithuania is extremely low2 compared to many EU Member States. Therefore, any household receiving slightly higher income than the poverty threshold is not classified (according to the methodology of calculation of the indicator) as a household living in poverty (Blažienė, 2011).

Table 2. At-risk-of-poverty rate and in-work poverty rate in Lihuania and EU-27, percent

	2005	2006	2007	2008	2009
Lithuania					
At-risk-of-poverty rate	20.5	20.0	19.1	20.0	20.6
In-work poverty rate[3]	10.0	10.0	8.0	9.4	10.4
EU-27					
At-risk-of-poverty rate	16.4	16.5	16.7	16.4	16.3
In-work -poverty rate	8.2	8.2	8.5	8.6	8.4

Other indicators for 2009 that show the relevance of in-work poverty in Lithuania are:

- The at-risk-of poverty rate among single employed individuals in Lithuania was 16.1 percent (EU-27: 10.4 percent).
- The in-work poverty indicator of individuals with lower than secondary educational attainment was 21.1 percent (EU-27: 16.4 percent).

There were 191,000 part-time workers, which accounts for 19.8 percent of the population employed in the national economy. By comparison, in 2008 the number of part-time workers was 156,800, or 13.7 percent of the total employed population (Blažienė, 2011). The figures above suggest that having a job often does not provide adequate standards of living. This fact together with the high unemployment rate are seen as a push effect, encouraging people to look for more attractive working and living conditions abroad.

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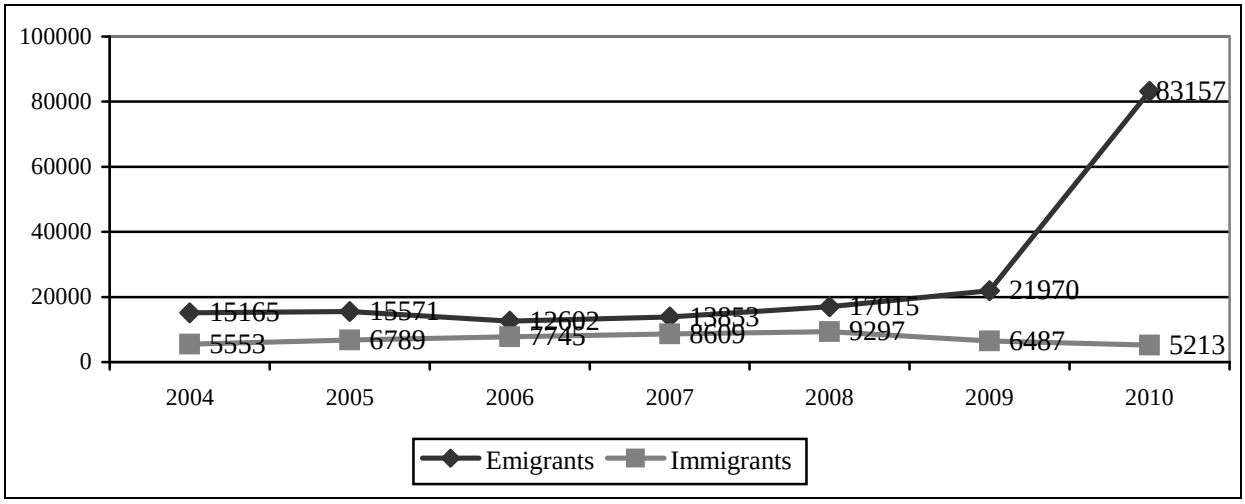
does not exceed the fixed ratio of property value. Cash social assistance is equal to 90 percent of the difference between the SSI per family or single resident and the average monthly income of the family or single resident.

[2] E.g., in 2005 (latest data published by the EUROSTAT) the poverty threshold in Lithuania was EUR 1,235 per person, whereas in France it was EUR 9,567.

[3] The share of persons who are at work and have an equivalised disposable income below at-risk-of-poverty threshold, which is set at 60 percent of the national median equivalised disposable income (after social transfers).

Emigration of population. Despite the fact that emigration decreased (from 15.5 thousand to 12.6 thousand) in 2006 for the first time since Lithuania's accession to the EU, the pace of emigration has accelerated again during the period of the economic crisis. In addition, 7.7 thousand persons (or 14 percent more than in 2005) immigrated to Lithuania. This situation was mainly induced by falling or lost income, rising interest rates on consumer credits, or housing loans (taken in the national currency). Moreover, the social and economic policy implemented in the country had little focus on social problems . In 2008, the number of emigrants from Lithuania grew by 22.8 percent, as compared with 2007 (from 13.8 thousand to 17.0 thousand); meanwhile, the increase in the number of immigrants to Lithuania stood at merely 8 percent (increasing from 8.6 thousand to 9.3 thousand).

Figure 6. Extent of international migration in Lithuania in 2004-2010



Sources: Statistics Lithuania. Data of the International Migration Survey.

The extent of emigration did not decrease in 2009 either. According to statistical data, around 22.0 thousand persons emigrated from Lithuania in 2009. Bearing in mind that the Lithuanian economy is foreseen to recover only in 2011-2012, Lithuania is likely to see even higher rate of emigration in 2010, along with the recovery of economies of foreign countries.

In April-August of 2010, the magnitude of emigration from Lithuania was high (average of 10.7 thousand emigrants per month). This can be explained by the obligations that are stated in Lithuania's Health Insurance Law, which demands country residents pay health insurance premiums. In this context, the change of residence from Lithuania to a foreign country could be declared by those migrants who have lived abroad before. During the first ten months of 2010, 74.1 thousand people declared their departure from Lithuania, which is four times more than during the same period last year. According to the Department of Statistics, every second or third person who was absent from Lithuania in 2010 did not declare his or her departure.4

As a result of increasing migration, Lithuania may lose additional 100-150 thousand residents in the long run. This is particularly alarming because Lithuanian citizens find it increasingly easy to adapt to the socio-cultural environment of foreign countries (particularly English-speaking countries) and they tend to stay there permanently. Increased emigration entails a wide range of long-term social consequences, having a negative impact not only on individual households but also on the country as a whole and its economic potential. Emigration entails a decline in population, "brain drain", demographic ageing, and other problems.

Increase in the crime rate. The statistical data analysis provided by Gruževskis and Zabarauskaitė (2008) has showed that economic decline, accompanied by rising unemployment and decreased household income lead to an increased crime rate. Although the total crime rate in Lithuania went up about 4 percent in the first quarter of 2009, the number of

[4] General population and housing census 2011 will allow a clarification of the extent of emigration and population for 2001-2010.

economic crimes increased considerably: the number of cases involving the counterfeiting of currency and securities increased 158.6 percent (from 237 to 613 cases). Fraud cases increased 59.1 percent (from 915 to 1456). Furthermore, the unlawful production of alcohol and the number of crimes committed by persons under the influence of alcohol nearly doubled during the same period (as compared with the previous year). If such trends persist, the total number of criminal acts in Lithuania may increase by 27 percent in 2012 (against 2008) and constitute about 3 thousand criminal acts per 100 thousand residents. The increased crime rate is expected to continue until 2012-2013 due to the fact that restraints on economic crimes take longer to develop and are related to a rise in the standard of living in the country (Gruževskis, Zabarauskaitė, 2008). It also should be mentioned that in 2008 Lithuania led Europe in the number of homicides, suicides, and car accidents caused by drunk drivers (Eurostat). These facts indicate a severe destruction of the social structure.

2. KEY INDICATORS OF CHANGES IN LABOUR MARKET TRENDS

Employment indicators were uneven during the different periods of labour market development. The average annual rate of employment until the decline (2001-2005) began to grow quite rapidly (from 57.2 to 62.6 percent). Employment growth continued, and the average rate in 2007 reached its maximum level during the reference period (64.9 percent). However, in 2008-2009 it decreased significantly, by 60.1 percent. The lowest employment rate during the period was in 2001, when the employment rate was only 57.2 percent. The key factors influencing employment growth were the improvement of the economic situation by 2008 and incentives from the European Union. However, there was a drastic change during the entrenched economic crisis: employment and unemployment rates significantly deteriorated. (Some reached 2002 levels, which was before Lithuania's accession to the EU). In other words, during the last two years major adverse employment and unemployment figures actually cancelled the positive trends in the labour market changes that took place over the previous five boom years (until 2008).

Table 3. Core labour market indicators

	2004	2005	2006	2007	2008	2009	2010
The total number of employed, thous.	1436.3	1473.9	1499.0	1534.2	1 520.0	1415.9	1343.7
Employment rate, total (population aged 15-64), in %	61.1	62.6	63.6	64.9	64.3	60.1	57.8
The total number of unemployed, thous.	184.4	132.9	89.3	69.0	94.3	225.1	291.1
Unemployment rate, total, percent.	11.4	8.3	5.6	4.3	5.8	13.7	17.8

Source: Department of Statistics

Employment dynamics. While analysing the dynamics in national labour market it is worth highlighting the positive changes in employment of elderly people. The employment level of the people aged 55-64 since 1998 rose from 39.8 percent to 53.1 percent in 2007. Despite the fact that the situation got worse in 2008.

It must be stressed that the relatively high employment of women is a distinct feature of the Lithuanian labour market. During the period of economic downturn, the women's employment rate dropped by 3.2 percent, but it was still higher than that of men.

The youth employment rate was lower than the employment rate of other social groups. At the beginning of the economic recession, the employment of young people in the country shrank from 26.7 percent in 2008 to 21.5 percent in 2009. Such a drop was the sharpest among other labour force groups. On the basis of the lessons from the „Russian crisis" in 1999, it is obvious that the outcomes of the economic recession on young people are very severe. It is probable that the employment rate of young people will raise much more slowly than average once the economy improves.

Table 4. The employment rate and its dynamic by the main target groups

	2005	2006	2007	2008	2009	2010
Employment rate (15-64)	62.6	63.6	64.9	64.3	60.1	57.8
Women employment rate	59.4	61.0	62.2	61.8	60.7	58.7
Youth employment rate (15-24)	21.1	23.7	25.2	26.7	21.5	19.2
Elderly employment rate (55-64)	49.2	49.6	53.4	53.1	51.6	48.6

Source: Department of Statistics

Unemployment changes. The lowest number of unemployed people in Lithuania was recorded in 2007, when the unemployment rate reached 4.3 percent. Nevertheless, by the end of 2008, when the economic recession began, the unemployment rate rose quickly. In 2009, it was almost 14 percent, and in 2010 it had climbed to 17 percent. The changes in the unemployment level of different social groups in fact are similar to the dynamics of average index but the changes in youth unemployment rate were especially prominent. In the period 2000-2007, it decreased from 30.1 to 8.2 percent, but in 2008-2010 rose to 35 percent.

The variations of the unemployment rate of men and women were lighter than for the young target goup. In 2004-2005, the unemployment level of women was higher than men. Nevertheless, the situation has changed since 2006: the women's unemployment rate became lower than men's (except in 2007, when the indices were equal). During the economic recession, the unemployment level of men increased faster than women. In 2010, it reached 20 percent (QIII).

Table 5. The average annual number of unemployed and the dynamics of the unemployment rate (thous. and percent)

	2004	2005	2006	2007	2008	2009	2010
Number of unemployed, (thous.)	184.4	132.9	89.3	69.0	94.3	225.1	291.1
Total unemployment rate (15-64), in %, of which	11.4	8.3	5.6	4.3	5.8	13.7	17.9
Women	118	8.3	5.4	4.3	5.6	10.5	14.6
Men	11.0	8.2	5.8	4.3	6.1	17.3	21.5
Youth (15-24)	22.5	15.7	9.8	8.2	13.4	29.2	35.1

Source: Department of Statistics

It is clear that the dynamics of different indices vary substantially. According to the data of Statistics Lithuania, the situation of the national labour market started to deteriorate in 2008, but the number of unemployed people who belong to certain target groups who registered in public employment offices were noticed as early as 2006 and 2007. It can thus be assumed that those indices were more sensitive to the approaching economic recession. Even during a strong economy, people without vocational education have faced unemployment problems more often. The number of individuals who belong to this target group started to increase as early as 2006.

In 2009, the number of registered unemployed accelerated enormously. Compared to 2008, the number of unemployed men increased dramatically (from 11 to 217.2 thousand) and the number of unskilled individuals increased from 84 to 145.2 thousand.

Table 6. Job seekers and the unemployed (annual number of registered individuals, thous.)

	2004	2005	2006	2007	2008	2009	2010
Registered job seekers, of which:	221.6	178.3	176.7	186.4	241.0	383.2	312.1
Unemployed	204.3	163.9	160.8	166.7	214.2	369.4	311.2
Women	101.1	85	87.5	90.5	103.2	152.2	139.1
Men	103.2	78.9	73.3	76.2	111.0	217.2	172.2
Youth	40.6	29.1	26.1	29.6	38.6	79.6	44.7
Without vocational education	66.5	56.7	59.9	66.3	84.0	145.2	…
Without job experience	…	…	19.3	22.3	24.5	47.3	…

The analysis of statistical data shows the changes of the situation in the labour market of different population groups, especially the situation of vulnerable groups. The most significant manifestations of the crisis were observed in the field of employment. Examining the structure of the labour force reveals that the effects of economic slowdown has primarily impacted the most unprotected population in the labour market. The changes in labour supply during the economic recession. The number of clients in public employment offices, the increased number of people receiving social benefits, and the changing structure of the unemployed since 2008 created new conditions for implementation of active labour market policies (ALMP).

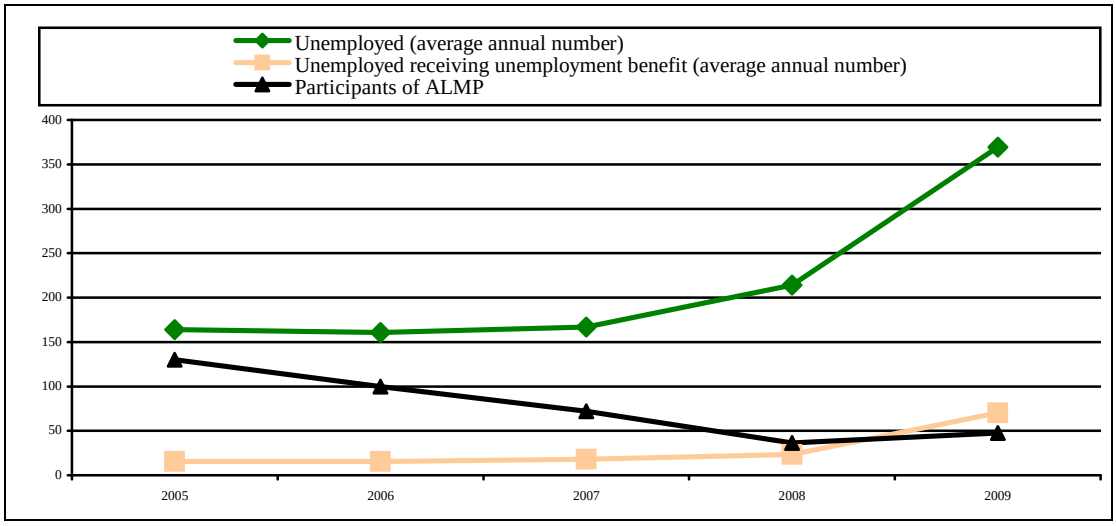
During the economic downturn, the unemployed changed in both quantitative and qualitative terms. At the beginning of the recession (end of 2008 - beginning of 2009), the share of people who recieved additional support guarantees among all unemployed people had decreased. In 2010, the situation changed again. When the health insurance situation became clear, the share of unemployed without work experience and long term unemployed stabilised. In 2010, the share of

unemployed people without a work record consisted 23.4 percent (in 2009 – 12.8 percent). Those who had a gap in employment for 2 or more years consisted 22 percent (in 2009 – 14.3 percent).

Forty-one percent of clients of the employment office have no vocational education. Although the share of unskilled people in total number of unemployed remained stable (about 40 percent), the absolute number of them has increased. Comparing the years 2008 and 2009, the share of unemployed men increased up to 60 percent. It than decreased to 57.7 percent in 2010. Almost every fifth registered unemployed person is older than 50 (18.6 percent). Every fourth is under 25 years old (24.4 percent). The number of individuals who are entitled to the additional employment support has increased again since the middle of 2010 because of an amendment of the Law on Employment.

Among other problems related to the structure of labour supply, it is necessary to mention rather sizeable territorial disparities in unemployment. According to the data of the Lithuanian employment office from the end of 2010, the highest rate of working-age population registered as unemployed was in the municipalities of Ignalina (21.3 percent), Mazeikiai (19.8 percent). and Zarasai (19.4 per cent.). The lowest number of unemployed was in Neringa (5.7 per cent.), Birstonas (10.7 percent), and Siauliai (11.3 percent). In Lithuania's big cities, the rate of registered unemployment was lower than the average in the country. (Lithuanian labour exchange, 2011). Role of active labour market policy measures during the economic recession. From 2003 to 2008, the number of participants of active labour market policies (ALMPs) in Lithuania decreased. The share of ALMP participants among total number of unemployed also decreased.

Figure 7. Number of unemployed, persons in active labour market policies, and recipients of unemployment insurance benefit (per year)



Source: Lithuanian labour market in figures 2005-2009.

More significant changes in the application of ALMP measures were observed in 2008. Compared to 2007, the number of participants of the measures decreased dramatically. The analysis of the data from the beginning of 2008 and in 2009, when the number of unemployed increased dramatically, shows that during the same period the total number of participants in ALMP was very low. The share of women and long-term unemployed among the participants of the measures were also lower, but the young and disabled people have been actively involved in ALMP measures.

According to the 2010 data, 57.8 thousand individuals were involved with active labour market policy measures. Individuals involved in different ALMPs currently constitute 3.5 percent of the all registered unemployed. An analysis of the targeting data of the different ALMP measures during the recession period (2008 – 2010) reveals an increased volume of almost all the programs.

Table 7. Number of people directed to the active labour market policies (by measures, during the period)

	2005	2006	2007	2008	2009	2010
Number of unemployed persons directed to ALMPs (total)	129.9	*99.8*	*72.1*	*36.3*	*47.5*	*57.8*
Vocational training	19.8	19.6	24.4	9.8	13.9	6.5
Non-formal education	…	…	5.5	1.4	…	…
Vocational rehabilitation	0.01	0.2	0.3	0.3	0.3	0.5
Supported employment. Of which:						
Subsidised job placement	…	2.7	11.7	4.9	9	12.3
Support for acquisition of professional skills	…	1.3	4.9	1.7	3.8	6.5
Public works	39.3	34.4	22.4	16.4	18.8	31.9
Support for establishing of job places	4.3	3.8	2.4	1.4	0.1	0.1
Job rotation	…	0.1	0.6	0.4	0.6	0.6
Business license	…	4.2	7.1	7.0	7.7	14.5

Source: Lithuanian labour exchange.

During the period of economic downturn, ALMP could be an important tool to reduce social tension and maintain employment of vulnerable groups. ALMP measures implement the following key tasks in order to mitigate the economic consequences and to speed up the recovery of the country's labour market: promotion of labour demand, improvement of the quality of the work force, reducing the consequences of financial crisis for unemployed persons, and promotion of small business.

The changing structure of the unemployed and declining labour demand creates a need for active labour market policies. During the period of recession, it would be appropriate to extend the list of the groups who are entitled to participate in ALMPs. More attention and more preventive measures should also be implemented in the areas with mass unemployment in order to forestall the breakdown of social structures. Unfortunately, the financial allocations for ALMPs from the state budget after the beginning of the crisis dropped three times (from 69,524 thous. litas in 2008 to 22,471 thous. litas in 2009) and the current level of implementation of those measures was maintained mostly by European Social Fund.

It can be argued that ALMP measures in Lithuania were not actively used to reduce unemployment and to preserve existing jobs during the economic downturn. Given the extent of long-term unemployment in the country, it is a low figure. Since March 2011, the number of long-term unemployed has increased by 140 thousand, a 120 percent increase compared to the same period of 2010. At the same time, the number of unemployed people receiving unemployment benefits declined from 70.5 thousand up to 45 thousand during the same period.

Conclusions

As historical evidence shows, a general lesson is that one must respond quickly to economic crisis before it gets worse. The measures selected should have a quick impact on the economy and population with the main focus on employment issues. Unfortunately, analysing the macroeconomic indicators of the Lithuanian economy in the period of 2004-2009 suggests that the public management system had no sufficient potential to meet challenges of economic recession. Significant variations in the employment rate and earnings indicated that there are no mechanisms for stabilizing the economic fluctuation in the country.

A reduction in national production, an increase of unemployment (especially youth unemployment), a drop in average wages, a rise of prices for utilities, and a reduction of social guarantees all limit citizen participation in the Lithuanian labour market. The migration flows – rising number of emigrants and shrinking number of immigrants - illustrates this point.

Another social problem is the worsening standard of living of the unemployed. The number of unemployed who lost their right to unemployment benefits is increasing. A significant reduction in personal income often causes the unemployed person (or family) to fall into the ranks of socially disadvantaged people. It should be noted that the reduction of unemployment benefits (from 1 January 2010 and December) has triggered protests and social anxiety. However, a significant decrease in social security and standard of living of unemployed persons has led to the development of informal employment.

While assessing the main drivers and obstacles for economic and employment growth in Lithuania, the unfavourable political situation and imperfections in public administration should be mentioned. Those factors adversely affect the opportunities for economic development. The deficiency of institutional trust, which at the end of 2010 reached its lowest levels, is concerning. Only 9 percent of the respondents relied on Parliament (Seimas) and 17 percent on government and its subordinate institutions (Baltijos tyrimai, 2010).

Despite the economic downturn, which led to the fastest growth of unemployment in the EU (over 300 percent in the period of 2008-2010), and the European Commission's recommendations, Lithuania has failed to increase the role of its employment policy. During the recession, the number of employees at the Lithuanian Labour Exchange has dropped, and the Lithuanian Labour Market Training Authority has been abolished. Unemployment benefits have reduced while the number of unemployed has increased. Although the average unemployment benefit was up to 35 percent of the average wage, less than 20 percent of registered unemployed have received it by the end of 2010. A rapid growth of long-term unemployment and the decreased availability of business loans should also be mentioned to illustrate the importance of cohesive employment policy at public level.

Lithuania's future is threatened by high structural unemployment, which should be prevented by current government policies. The Government has taken various measures to carry out structural reforms. However, in our opinion, the efforts were not sufficiently effective due to the following factors:

- the actions implemented were not compatible and were not sufficiently complex;

- the actions taken are not supported by the public (including by different interest groups or trade unions);

- the actions do not directly focus on job creation.

Growing numbers of the formerly unemployed who were working under a business license showed that such ALMP measures could accelerate the development of self-employment during economic recession. More attention should be given to the development of small and medium businesses. Such measures are aimed at both the labour supply and labour demand, and could contribute to the acceleration of private sector recovery. However, it is clear that long-term effects of such measures depend on an overall favourable economic climate for the development of small business.

The first modest observable signs of economic recovery in 2010 suggest that the country managed to curb the economic recession. Nevertheless, the situation remains difficult in the national labour market and social security system.

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Youth Intentions to Public Administration Development: Baltic States and Germany Case Studies

Introduction and topicality

As in any other organization there is uninterrupted development process in public administration going on for decades and in some countries for centuries. Public administrations in the Baltic States and Germany have gone through many changes – the foundation of the countries, the lose of independence, wars, regaining of independence, baby booms, changes in political regimes and economies, involvement in international relations, population migration waves. Not only have the governments been changing every 2-4 years, but also the generations, the people and this process of change will go on as long as the human civilization will exist. In the next 10 to 30 years, the work carried out by public administration will be taken over by the next generation, namely young people currently attending schools and universities and receiving state services provided by existing policy-makers who are currently planning and ensuring the development of public administration. They are implementing various kinds of national and supranational policies, including youth policy which in its turn is mainly targeted at those young people who will replace the aging generation. Will they? On the background of demographic statistics (low birth rates, high emigration) and economic statistics (high unemployment, debts, lower income), which also affect demographic statistics, as well as taking into account the overall attitude to public administration, the answer to the abovementioned question might seem debatable.

Youth have always been an important part of society. "Youth is our future" is a saying we can hear quite often in speeches given by both experienced and new speakers in various discussions on economic, social, political, cultural and public administration topics. Although, for objective reasons, youth – being the future – is not in the very centre of focus of public administration, nevertheless it is given a significantly important part of public administration resources, including, personnel, money, attention, time, place, legal acts and many other. There are countless youth policy documents and programmes in European Union[1] as well as in every country[2;3;4;5] working toward different directions of youth development and trying to cover all stages of youth needs in Maslow pyramid. The care of youth, of course, comes back to public administration development in indirect ways through nation's sustainability, welfare, socio-economic development, cultural and intellectual growth, competitiveness and other ways.

Youth represents a specific, large and strategically important group of state clients – receivers of state services. According to the author – client of public administration is everybody, every person of society, who receives at least one service given by any of public administration institutions, like, social security, state border control and protection and many others. There are different names and titles used for describing public administration actions which objective is give benefits to individuals. Most commonly used terms are public service, social service, government service, and public administration service. Public services are material or nonmaterial benefits defined in legal acts that are offered to individuals by government institution in order to ensure society's need for receiving these services[6]. Customer relationship and effective strategic planning is remarkably topical and still improvable process that is being recognized as good practice of management and at the same time it also makes healthy competition in public administration and private business sector. For instance, in United States customer satisfaction is being regularly evaluated in all business and public fields using a common methodology – *American Customer Satisfaction Index (ACSI*), which is defined as

[1] European Commision Directorate-General for Education and Culture, EU Youth Strategy 2010 – 2018; http://ec.europa.eu/youth/news/news1458_en.htm
[2] Estonian National Youth Council. Youth Policy Platform 2010. http://www.enl.ee/UserFiles/Organisatsiooni%20tekstid/noortepoliitika/ENLi_noortepoliitika_platvorm_ENG.pdf
[3] Ministry of Social Security and Labour, Republic Of Lithuania. Youth Policy. http://www.socmin.lt/index.php?-1855022895.
[4] Council of Europe. Country Sheet On Youth Policy In Germany. http://youth-partnership-eu.coe.int/youth-partnership/documents/Questionnaires/Country/2010/Country_sheet_Germany_2010.pdf
[5] Ministry of Education and Science, Republic Of Latvia. Youth Policy. http://izm.izm.gov.lv/youth.html
[6] "State and local government`s services electronization model. Guidelines for implementation of public services electronization project", The Secretariat of the Special Assignments Minister for Electronic Government Affairs, Riga, 2006. http://www.eps.gov.lv/files/ELM.EPAK.NOD.EMODEL.Vadlinijas.1.1.0.2006.07.31.doc

the weighted average value of the three survey indicators: perceived quality (Perceived quality), perceived value (Perceived value) and customer expectations (customer expectations). Normally the assessment results are higher for products, services and the lowest, lower - the Government and public authorities[7]. A lot of public and private sector institutions and companies are very interested in exploration of new ideas and research methods and results in this field. Researching, developing and discovering questions of customer relationship and effective strategic planning, and rapid implementation of solutions have become a true necessity for progress of social, political, and economical processes.

Private business sector in contradiction to public administration for longer time already admits that the most important is the client but not the profit, quality or other business matters. Both quality and profit depend on the client. The client defines these matters and the customer relations management has been rapidly developing in private sector. Companies are trying hard and take lot of effort to know their clients better, to individualize service, to keep and attract clients, to systematize the relationship using information management equipment including web based technologies[8], which now allows to determine which client has the greatest impact on profits and apply the appropriate segmentation method of customer behavior analysis. In addition to improving customer satisfaction, it is possible to direct them to appropriate services, based on information and knowledge about customer.[9] In private sector`s customer relationship management youth is specifically distinct group both in terms of clients as well as in terms of overall business environment shapers – their skills, abilities, attitudes, perception of achieving results help enterprises across all disciplines adapt and enable best performance.[10]

In recent decades similar ideas have come also in public administration. A new public administration culture is developing, at the center of which attention is paid to the client's needs and desires. Public institutions are implementing the principles of private business, focusing more on cooperation, cost reduction and the achievement of results. Cooperation between the client and public administration has to become as simple as possible in order to diminish the administrative burden on individuals and businesses so as to save customers' time and money and support the further development of businesses. The significance of the client in public administration has recently become more apparent in the objectives of national and EU strategic documents that underline expanding the availability of public services. Many public administrations in Europe are increasingly focusing on a particular strategic objective, namely to become a service organization so that clients` consider them to be client-orientated.

Human resources, personnel development or talent management, the latter being the newest trend in conventional human resources management process, are crucial part of organizations' sustainable development. The same level of importance and attention in planning an organization`s sustainable development is devoted to both the personnel or internal clients and external clients – consumers of organization`s products and services. The higher the level of customer satisfaction and the better the image of the organization, the better it is perceived by both types of clients. Besides, people interact closely and are even switching within these groups, thus one affect the other – higher level of satisfaction of organization personnel (internal clients) will lead to a higher level of customer satisfaction and other way around. The interaction between these two groups is very sensitive and important, especially if we look at it through the perspective of future personnel and the development of an organization, both, private or state. Public administration's strategic planning in terms of human resources and customer relations management are as important as in the private sector. Public administration has to cover everyone's needs for public services while the private sector is willing to do so and may cover the specific part of society and their needs according to company`s specialization. Although the impact of customer relationship management and personnel management are very interconnected, in specific terms of development, as every organization, also public administration must ensure its own sustainability. So the organization must plan ahead both, the customer service and its own development in order to stay flexible in nowadays rapidly

[7] W.B.Lin "The exploration of customer satisfaction model from a comprehensive perspective", Taiwan, National Formosa University, 2006.
[8] F.Wang, M.Head "How can the Web help build customer relationships? An empirical study on e-tailing", Ontario, Canada, University Avenue West / McMaster University, 2006; www.sciencedirect.com
[9] H.S. Park, D.K. Baik "A study for control of client value using cluster analysis", South Korea, Kyungin Women's College / Korea University, 2005, p.5-6.
[10] John C. Beck, Mitchell Wade, How the Gamer Generation Is Reshaping Business Forever. Harvard Business School Press. 2004.

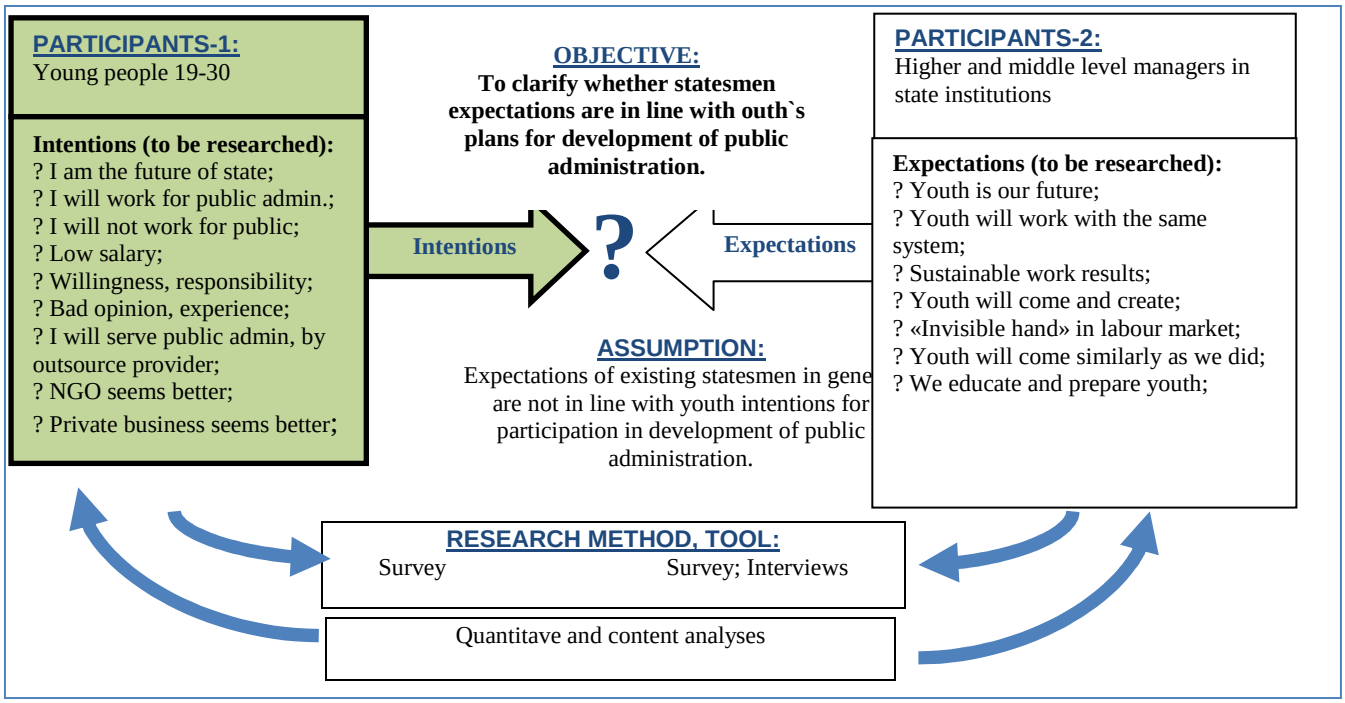
changing environment and keep covering the needs of its clients and ensure their satisfaction and trust which is very important precondition of organization`s existence. “Client satisfaction is a key to keeping clients”[11]. It is important that a government policy-makers and performers have a clear position on the involvement of younger generations. This will make it possible to develop an appropriate youth policy planning documents. It is also important to be aware weather the expectations contained in stand of the current government leaders and youth policy planning documents are in line with young people's desires, ideas and their stands. This, in its turn, will enable appropriate and clear mutual contact, mutual understanding, thereby promoting the participation of civil society and more efficient public administration, increasing its membership and customer satisfaction. Consequently, author defines the main research problem as a challenge to create a clear relationship between the current government leaders, youth policy-makers and youth generation.

To sum up, a list of direct and indirect arguments can be made supporting the topicality, necessity and influence of this research:

1) Government and its institutions need to know their clients;
2) Improved youth policy;
3) Enabled appropriate and clear mutual understanding of policy-makers and youth;
4) Increased participation of civil society;
5) More efficient public administration that can lead to a higher value added in private sector;
6) Improved customer satisfaction that improves the efficiency and welfare;

Finally, it is necessary to point out that the every kind of development itself should not be considered only on the problem-based background. It can be planned and performed also taking into account its possible future value and significance. Wide range of customer relationship researches has proven themselves to work in private sector, which has been a great teacher of public administration for centuries. Taking that into account public administration should strive for excellency facing possible future value it can obtain. See Figure 1 for visualization of research`s scheme.

Figure 1. Research scheme



Source: Author

[11] P.Rauyruen, K.E.Miller “Relationship quality as a predictor of B2B customer loyalty”, Sydney, Australia, University of Technology, 2005, p.2,5.

The research methodology and sample description

The main research tool was a questionnaire. The electronic version of the questionnaire in English is available online12. The questionnaire included 48 different statements formed into 6 major groups:

- questions about youth intentions towards participation in public administration development;
- questions about motivating factors;
- questions about dissuading factors;
- questions about comparative factors;
- questions about all the previous factors' significance;
- demographic questions (age, sex, education, geography etc.)

Each statement in the questionnaire was provided with an evaluation scale from 1-10, 1 being "strongly disagree with the statement" or "very unimportant factor" and 10 being accordingly strong agreement with the given statement or evaluation of a given factor at the highest level of importance. Overall, the research questionnaire was designed to reach the objective of the first part of research – is the youth future of state development and how they see the possible participation in public administration development. The questionnaire was distributed both electronically and in a paper form. Electronically it was prepared by Google product Google Docs which also provided very convenient data collection for further analyses. The electronic version of questionnaire was distributed via emails and through social networks among many youth organizations and individuals in Baltic States and Germany that met the only target group criteria – age 18-30. In a paper format it was handed and collected from young people at schools and universities in Latvia.

To rebut the argument that major part of research participants are internet users thus seemingly not representing the general population, author would like to emphasize that sample selection of research are young people among which the regular internet using level in 2010 varies from 93% Lithuania to 97% in Estonia and has been steadily growing ever since the beginning of internet appeared13. Besides, the essence of the research relates to active social development where internet using level is nearly 100%. So, the participants included in sample size represents the general population of research target audience and is completely related to essence of the research. The research data were collected and analysed using Google Docs, MS Excel and SPSS softwares. For data analyses following main methods were used: statistical data analyses, cross-tabulations, multivariate analysis: factor analysis, correlation analysis and indicators of variability, 5 „whys" technique. There are in total 2307 participants in sample size from four respective countries. See Table 1 for detailed view on sample description.

Table 1. The sample description (compilation of main characteristics)

Questionnaire`s demographic questions		**Estonia**	**Latvia**	**Lithuania**	**Germany**
	N	403	1001	411	492
37. Sex	Female	59%	76%	61%	52%
	Male	41%	24%	39%	48%
38. Age	below 20	17%	19%	24%	3%
	21-30	79%	78%	73%	95%
	above 30	4%	3%	3%	2%
39. Education	Secondary school	9%	7%	9%	8%
	Bachelor or professional studies or degree	64%	65%	59%	65%
	Master studies or degree	25%	26%	18%	25%
	Doctoral studies	3%	1%	3%	5%
43. Field of work	Not working or looking for a job	38%	42%	47%	51%
	Various kinds of employment (public sector, service field, NGO, trade, banking, education, a.o.)	62%	58%	53%	49%

Source: author`s research results

[12] The research questionnaire in english is availabe online at this shortened URL address - http://goo.gl/LjXaX.
[13] The United Nations Economic Commission for Europe Statistical database.
http://w3.unece.org/pxweb/dialog/Saveshow.asp?lang=1. Last time visited on July 28, 2011.

Youth intentions

The first part of the questionnaire included nine statements about different options of how to participate in public administration development. These questions were important to evaluate one of the main research hypothesis – the conceptual approval from young people that (whether) they are the future of state development and also to identify more detailed outh`s plans and ways how they see the possible participation in public administration development. First two statements are about youth general and individual perception of them being the future of the state (see Table 2) and then 7 more statements about specific fields to involve (see Table 3).

The average agreement with the statement "Youth is the future of the country" is quite similar among countries. Vast majority in all countries (91% - 95%) agrees with the statement that youth is the future of the country. The average evaluation in all countries is around 8,8 and the variance of average evaluations among countries is around 0,33 in scale 1-10. Also the fractional distribution is very similar – the variance among countries lies within three percentage points. The balance is the best in Germany where actually no one disagrees that youth is the future of the country. In consideration of individual belonging to the future of one's country ("2. I consider myself as the future of my country") wider variance in balance among countries can be noticed – up to 12% between Lithuania (61%) and Germany (73%). Latvia ranks the second with balance of 72% and Estonia is the third with 63%. Interesting, that Estonia, which later proves itself to be the most appealing public administration for youth in many factors, has the lowest level of agreement and one of the highest levels of disagreement with the statement "2. I consider myself as the future of my country". It results from comparatively high amount of young Estonians who does not have clear opinion about this question (see Table 2).

Table 2. Young people conceptual agreement on youth being the future of their country

Questions		**Average values in scale 1-10**			
		Estonia	**Latvia**	**Lithuania**	**Germany**
1. I agree with the statement "Youth is the future of the country"		**8,617**	**8,830**	**8,806**	**8,949**
Share of responses by scale fractions, %	1 - 4	1%	2%	1%	0%
	5 - 6	7%	6%	4%	5%
	7 - 10	93%	93%	94%	95%
	Balance*	92%	91%	93%	95%
2. I consider myself as the future of my country		**7,533**	**7,853**	**7,582**	**7,915**
Share of responses by scale fractions, %	1-4	10%	7%	13%	5%
	5-6	17%	13%	12%	17%
	7-10	73%	79%	75%	78%
	Balance*	63%	72%	61%	73%
The difference between questions, case results (share (%) of all answers by countries)					
„I consider myself as the future of my country" **LESS THAN** „I agree with the statement "Youth is the future of the country"		49%	51%	46%	59%

*Balance is calculated as difference between evaluations in scale fractions "7-10" and "1-4", where the first one represents the approval of a statement and the latter represents the denial. The difference shows more objective overall evaluation. For example, in the second question Latvian youth shows the highest approval of the statement (79%) and Germany follows with 78%, however Germany`s balance is better (73%) than Latvia`s (72%), because there are more young people in Latvia (7%) who disagrees with the statement than in Germany (5%).

Source: author`s research results

The results of interconnection of these first two questions about young people conceptual agreement on youth being the future of their country are more vigorous and were a little of a surprise. The difference between average evaluation of a general statement that "Youth is the future of the country" and the average evaluation of the statement „I consider myself as the future of my country" is quite significant, but the individual case results are even more substantial. The difference is calculated as a share of those cases where the evaluation for the second statement is lower than the evaluation for the first statement. The widest gap is in Germany – 59% of young people **consider themselves** as the future of their country **less than** they consider **general youth** as the future of the country. In Lithuania this indicator is 50%, Latvia – 49%, and in Estonia this indicator is still very high – 46% (See Table 2).

This difference may be interpreted in many different ways, but among others it partly proves the perception of collectively shared and individual responsibility, where on the background of possibility of general involvement the individual responsibility decreases. These results also relate to observation that can be widely seen in many dimensions of social and professional lives, i.e., people often know better what others should do and how others should perform in their field and speciality, however not that often it can be seen in ownership and responsibility of their own actions and their own field of work. Of course, it has deeper roots than just personal reasons such as trying to look better by making look others worse; fear of guilt, fear of losing a job, fear of criticisms, disapproval, and condemnation. The reasons of these fears in their turn have been deeply rooting in psyche of whole society during last century during wars, especially in Eastern part of Europe that was under dominance of Soviet Union where different mistakes, lower performance and initiatives could turn fatal. On the other hand, it can, of course, be justified by strong interconnectivity and interdependence of different fields of work both in public administration and private sector nowadays. For instance, courts partly depend of investigation made by police which in its turn depends on policy made by ministry of internal affairs, which in its turn depends on government policies and resources, which in its turn can depend on supranational policies and global market, and after all they all depend on ability of tax and customs administration bring income in the country that in its turn depend on private sector consumption and ability to generate added value, which again in its turn inversely depends on different government policies and ability to ensure fair and competitive business environment.

When talking about youth intentions towards participation in public administration development there are basically two major ways of how to participate:

1) Directly – through being employed by public administration institution;
2) Indirectly – through civil society, academia, NGO, private business and many other different ways that cannot all me named because of its wide variety and range.

Although on the one side A.Smith`s “invisible hand” in interaction between the supply and the demand (including public administration labour market) most probably is still working at full force, on the other hand it is considered not to be that simple. It is not just plain technical supply, the amount of working places in public administration that affect the youth intentions of participating in public administration development. In addition to more technical analyses in this very direct way of youth participation in public administration development (amount of vacancies, employment period, retention rates a.o.) there is also the indirect way of participation – through private sector, non-governmental organizations, social sphere, academia and others.

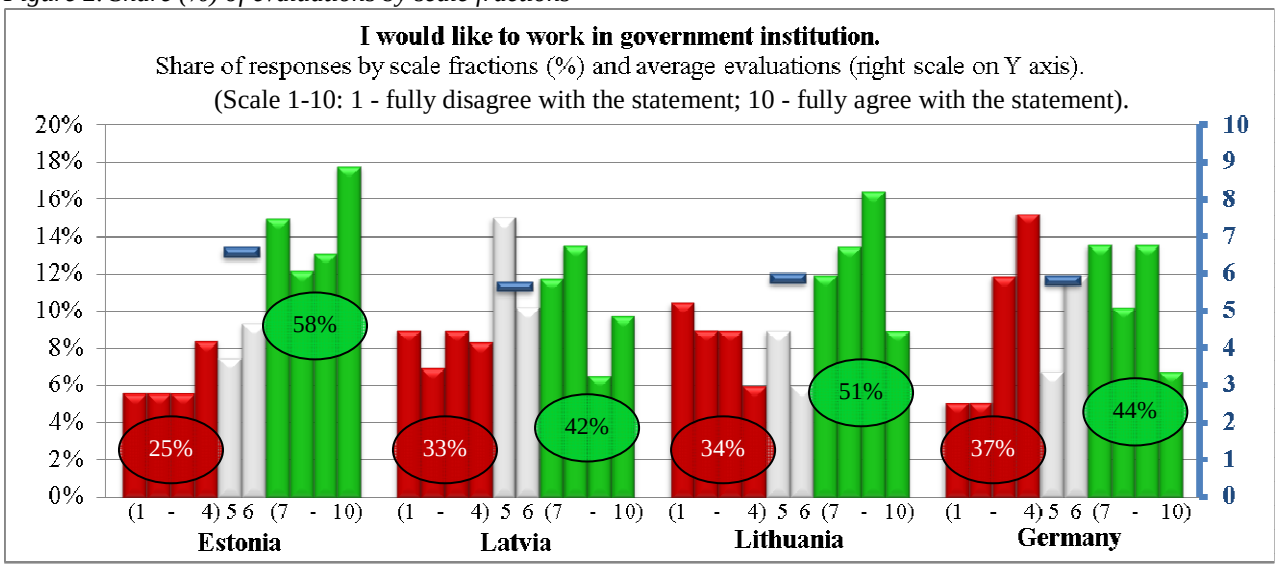
According to the author`s research, the situation with youth willingness and intentions towards participating in public administration development varies among countries. Further analyses will explore youth attitude towards 7 ways or platforms for participation in public administration development. The popularity of given seven choices of how to participate in public administration development – 1) work in a state sector, 2) work in a private sector, 3) work in a social sphere, 4) work in academia, 5) work in NGOs, 6) commenting (expressing an opinion in virtual environment and printed periodicals (internet blogs, articles, journals etc.)) and 7) becoming elected statesman – in a cross view by countries varies quite significantly, although three of the most popular and three of the least popular platforms for intentions of participation in public administration development remain practically the same in all countries covered, and they are – State, NGO, Private as most popular and commenting, running for elections, and academia as least popular areas.

The statements about possible ways of involvement in public administration development started with a question about direct involvement – “3. I would like to work in a national or local government institution”. The results showed that in Estonia they find working for public administration much more appealing than in Latvia, Lithuania and Germany (see Figure 2).

Estonian youth show the highest level of willingness to work in government institutions – 58% of participants evaluated their agreement with the statement by marks 7-10 thus showing their interest and willingness to work in government institutions in Estonia. Although the level of unwillingness to work in government institutions (amount of evaluations 1-4) in Estonia looks quite high (25%) still it is significantly lower in comparison to other countries, as a result the

balance (difference between share of marks 7-10 and 1-4) is quite scattered among countries. Overall, Estonia is ranking the first with highest average evaluation of 6,579 and 33% balance. Lithuania is following with average evaluation of 5,881 and twice as low balance – 16%, because less participants agrees with the statement (51%) and more participants disagrees with the statement (34%). Latvia and Germany has around four times as low balance (accordingly 8% and 7%) and average evaluations of 5,663 and 5,831. Although Germany has higher average evaluation than Latvia which results from higher level of agreement with the given statement and lower level of "I don`t know" answers, Latvia has insignificantly, but still a little better balance, because the level of youth unwillingness to work in government institution is higher in Germany. Figure 2 shows the distribution of evaluations by scale fractions.

Figure 2. Share (%) of evaluations by scale fractions



Source: author`s research results

Although working in government institutions seems quite popular way among youth intentions for future, it is not, of course, the only way and there are more popular sectors. Now, let`s focus more on that part of youth who doesn`t want to work in government institutions or have no clear vision about this statement – the share of such young people varies from 42% in Estonia and 49% in Lithuania to 56% in Germany and 58% in Latvia. Table 3 below shows the average evaluations and fractional distributions by scale on other given sectors.

Table 3. Youth`s plans for participating in public administration development

Questions		Average values in scale 1-10			
		Estonia	Latvia	Lithuania	Germany
4. I would like to participate in State development by running a private business		**6,364**	**6,420**	**6,537**	**6,017**
Share of responses by scale fractions, %	1 - 4	28%	23%	24%	34%
	5 - 6	20%	23%	18%	17%
	7 - 10	52%	54%	58%	49%
	Balance	24%	32%	34%	15%
5. I would like to work in the social sphere (doctor, teacher, police force etc.)		**5,355**	**3,883**	**5,119**	**4,542**
Share of responses by scale fractions, %	1 - 4	42%	63%	46%	63%
	5 - 6	21%	18%	16%	10%
	7 - 10	36%	19%	37%	27%
	Balance	-6%	-44%	-9%	-36%
6. I would like to work in academia and do research on public administration		**5,121**	**4,366**	**5,254**	**4,288**
Share of responses by scale fractions, %	1 - 4	42%	55%	43%	56%
	5 - 6	26%	20%	18%	19%
	7 - 10	32%	24%	39%	25%
	Balance	-10%	-31%	-4%	-31%
7. I would like to participate in state processes through the third sector (non-governmental organizations)		**6,617**	**5,881**	**6,776**	**6,898**

Share of responses by scale fractions, %	1 - 4	20%	32%	22%	22%
	5 - 6	26%	23%	16%	12%
	7 - 10	54%	45%	61%	66%
	Balance	35%	14%	39%	44%
8. I would express my opinion in a virtual environment and printed periodicals (internet blogs, articles, journals etc.)		**3,916**	**5,652**	**4,284**	**3,390**
Share of responses by scale fractions, %	1 - 4	61%	34%	58%	69%
	5 - 6	18%	23%	13%	17%
	7 - 10	21%	42%	28%	14%
	Balance	-39%	8%	-30%	-56%
9. I would consider running for government, parliament, and local government elections to become a statesman or politician		**4,785**	**3,559**	**4,657**	**4,407**
Share of responses by scale fractions, %	1 - 4	47%	66%	45%	58%
	5 - 6	19%	17%	24%	10%
	7 - 10	35%	17%	31%	32%
	Balance	-12%	-49%	-13%	-25%

Source: author`s research results

Analyses of the results in the first section of research questionnaire about youth intentions towards public administration development show that overall the most popular platform where to act giving support to public administration development in youth perception is non-governmental organizations (NGO). This sector has the highest average evaluation and the most positive balance among other sectors thus ranked 1st in Germany, Lithuania, and Estonia, and the 2nd in Latvia.

The second most popular sector varies among countries. In Lithuania and Germany it is private business sector, in Estonia – state sector, and in Latvia – NGO.

And the third most popular sector for youth to participate in public administration development overall is state sector, however in Estonia state sector was ranked the 2nd, so the third most popular in Estonia is private sector (see Table 4).

Table 4. Sectors ranking by countries based on different calculations

(based on average evaluations)					**(based on share of 7-10 evaluations)**					**(based on balance)**				
Rank	**EE**	**LV**	**LT**	**DE**	**Rank**	**EE**	**LV**	**LT**	**DE**	**Rank**	**EE**	**LV**	**LT**	**DE**
1	NGO	Private	NGO	NGO	**1**	State	Private	NGO	NGO	**1**	NGO	Private	NGO	NGO
2	State	NGO	Private	Private	**2**	NGO	NGO	Private	Private	**2**	State	NGO	Private	Private
3	Private	State	State	State	**3**	Private	Comm	State	State	**3**	Private	State	State	State
4	Social	Comm	Acad	Social	**4**	Social	State	Acad	Elect	**4**	-	-	-	-
5	Acad	Acad	Social	Elect	**5**	Elect	Acad	Social	Social	**5**	-	-	-	-
6	Elect	Social	Elect	Acad	**6**	Acad	Social	Elect	Acad	**6**	-	-	-	-
7	Comm	Elect	Comm	Comm	**7**	Comm	Elect	Comm	Comm	**7**	-	-	-	-

Source: author`s research results

Deeper analyses of youth intentions showed quite a many significant (medium and large) correlations (Pearson, r coefficient values). That part of youth who shows willingness to work in public administration institutions keep being persistent in positive attitude to public administration which is proved by higher correlation coefficients respective factors such as sense of being helpful in public administration (r=0,596), no interest in public administration (r=-0,460), lack of belief in public administration (r=-0,512), the public sector is a more interesting and challenging place to work than the private sector (r=0,423) and others.

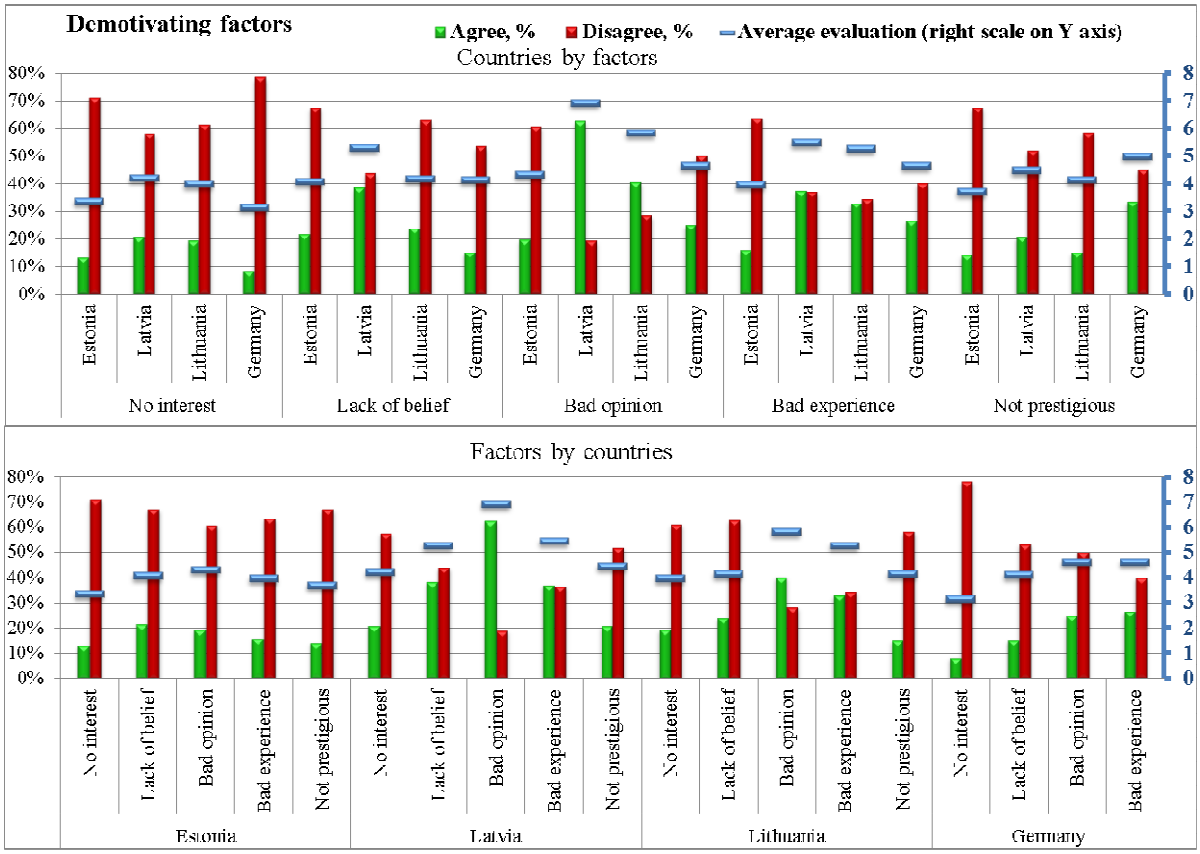
Motivating and dissuading factors

In the second and the third part of the questionnaire participants were asked to evaluate 3 motivating factors and 5 dissuading factors (see statements No.11-13 and No.15-19 in Table 5) that accordingly inspires or decreases youth`s motivation to participate in public administration development. All of the motivating factors (sense of responsibility, sense of being helpful and having own opinion to implement) were approved by more than 50% of youth population in every respective country and the average evaluations of motivating factors varies around from 6,95 – 7,15 in Estonia, Lithuania and Germany and around 6,3 in Latvia.

Having ones opinion especially among young people now has become quite important for society and public administration. Very vividly it now can be seen in Latvia, where after the dissolution of parliament and coming fresh elections. According to the social research agency TNS Latvia study 16% of all the economically active citizens of Latvia aged 18-55 want to see new faces joining the political party of Latvia ex-president – Zatlers Reform Party, as well as they want smart and active people in the party with their own opinion[14]. This factor has overall lower agreement and higher disagreement level than the rest of other two, and the highest approval is among youth in Estonia (61,3%) which is very closely followed by Lithuania (60,0%) and then Latvia and Germany (50%).

Vast majority of given dissuading factors (4 out of 5) turned out not to be approved by youth, i.e., there are more young poeple who disagreed with the given statements than those who agreed. The exception is a statement about having bad opinion of public administration in Latvia and Lithuania where more young people agreed with this statement than those who disagreed. Over 60% of Latvian youth and 40% of Lithuanian youth agree with the statement „I have a bad opinion of public administration" and less than 20% in Latvia and 28% of youth in Lithuania think the opposite. In Estonia the situation is symmetrically contrary in comparison to Latvia – 61% of Estonian youth disagree with the statement „I have a bad opinion of public administration" and 19,6% agree with it (see Figure 3).

Figure 3. Dissuading factors



Source: author`s research results

Comparative factors and their significance

Further in the research participants were asked to evaluate 8 comparative factors that might be both motivating and dissuading as well as to evaluate each of the previously evaluated factors` significance depending on the participant's personal and professional values, needs and individual assessment, for example, if a participant among other statements generally agrees with the statement that „*less limited career opportunities are in public administration than in the private sector*" or disagrees with the statement that „*initiative is appreciated more in the public sector than in the private sector*" then in the fifth part of the questionnaire it is evaluated how important participant rates the *career*

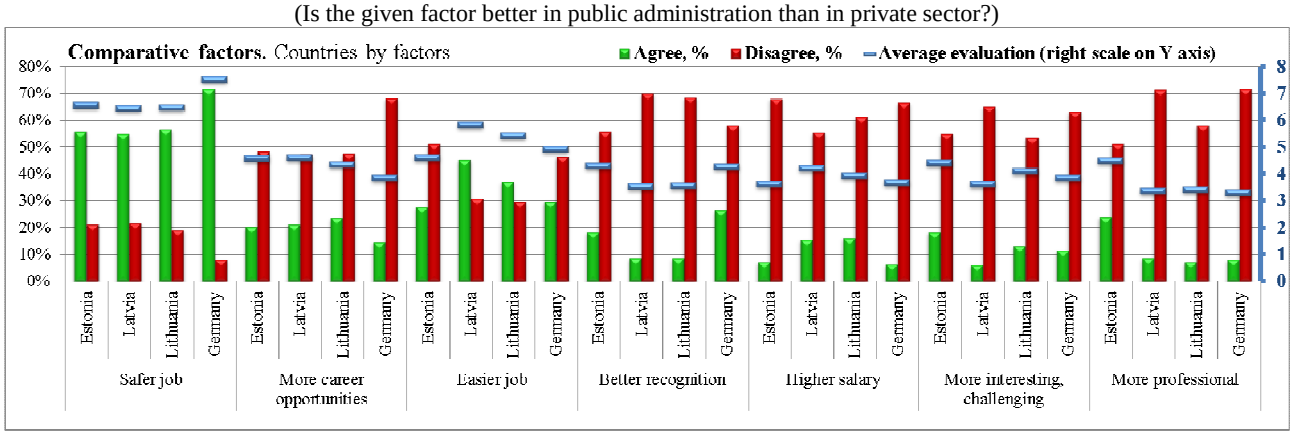
[14] Baltic News Network. „16% of citizens want to see new faces in Zatlers party". http://bnn-news.com/16-citizens-faces-zatlers-party-32464. Last viewed on July 18, 2011.

opportunity itself and *recognition at work* itself. It allows obtaining deeper and more objective analyses about each factor and technically calculating the factors` significance.

The comparative factors were given in a form "public administration versus private sector" (see factors No.21.-27 in table 5). Youth in all countries highly agrees that a job in public administration, including salary, is more guaranteed (safe and stable) than in the private sector and partly agrees that it is also easier. Other comparative factors have lower level of agreement thus also lower average evaluations (see Figure 4).

Figure 4. Evaluations of comparative factors

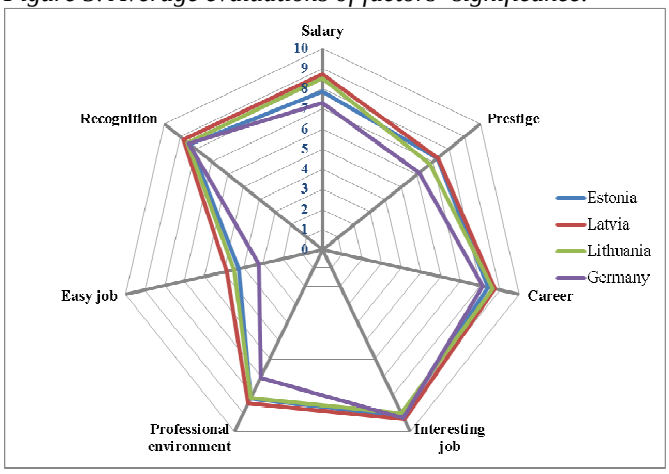
(Is the given factor better in public administration than in private sector?)



Source: author`s research results

Regarding factors` significance, in all countries most the given factors are of a high significance except of "Easy job" – over 60% of youth in Estonia and Germany, over 50% in Lithuania and 41% of Latvian youth consider the factor "Easy job" not significant. However, taking into account that over 20% of youth in Baltic countries evaluates this factor as important and its average evaluation varies up from 4-5, it is being considered and used in further analyses of the research (see Figure 5).

Figure 5. Average evaluations of factors` significance.



Source: author`s research results.

Overall public administration`s attractiveness indicator from youth perspective

Analyses of the research results by all sections gives us a detailed view of the country`s ranking by factors and the different factor's ranking by countries. These are important for detailed analyses of each factor and each country and form general views about countries, however it does not give an overall concrete representation of youth attitude regarding participation in public administration development and public administration`s attractiveness. Therefore, the overall public administration`s attractiveness indicator from youth perspective is calculated in a following way:

$$\overline{F_j} = \frac{\sum \frac{(\frac{\sum_{i=1}^{10} x_{ij}}{n_j} * \frac{\sum_{i=1}^{10} w_{ij}}{n_j})/10}{max_i}(\%)}{n_i};$$

$$\bar{x}_{ij} = \frac{\sum_{i=1}^{10} x_{ij}}{n_j};\ \bar{w}_{ij} = \frac{\sum_{i=1}^{10} w_{ij}}{n_j};\ F_{ij} = \frac{(\bar{x}_{ij} * (\bar{w}_{ij})/10}{max_i}(\%);\ \overline{F_j} = \frac{\sum F_{ij}}{n_i};$$

, where

j – country;
i – statement or factor used in calculation (see the list above) with an evaluation scale 1-10;
$\overline{F_j}$ – overall public administration`s attractiveness indicator in country "j";
F_{ij} – sub- indicator of statement "i" in country "j" expressed in percentage – describes the share of the evaluation of statement "i" in its maximum;
x_{ij} – evaluation of statement "i" given by respondent in country "j";
$\bar{x}_{ij}$ – average evaluation of the statement "i" in country "j";
w_{ij} – evaluation of factor`s "i" significance given by respondent in country "j";
$\overline{W}_{ij}$– average evaluation of factor`s "i" significance in country "j";
max_i – maximum possible evaluation of factor "i";
n_j – total amount of respondents in country "j";
n_i – total amount of statements used in calculation.

Step by step methodology description of how to get to $\overline{F_j}$:

1) Choosing the statement and factors (i) from the questionnaire that characterize youth`s attitude to public administration. There are 25 factors in total used for calculation of overall public administration`s attractiveness indicator out of which there are 18 statements` evaluations and 7 factors` significance evaluations.

1. Overall statements:
- 2. I consider myself as the future of my country

2. Plans, intentions:
- 3. I would like to work in a national or local government institution
- 9. I would consider running for government or parliament elections

3. Motivating factors:
- 11. I have a sense of responsibility towards my country
- 12. I feel that I could be helpful in public administration
- 13. I have my own opinion, which I would like to implement

4. Dissuading factors:
- 15. I have no interest in public administration
- 16. I do not believe that I can change anything in public administration
- 17. I have a bad opinion of public administration
- 18. I have a bad experience in dealing with public administration
- 19. Working in public administration is not prestigious

5. Comparative factors (used to weigh previous factors):
- 21. A job in public administration, including salary, is more guaranteed
- 22. Career opportunities in public administration are less limited
- 23. A job in public administration is easier and takes less effort
- 24. Taking initiative is more appreciated in the public sector
- 25. Salaries in public administration are higher

- 26. The public sector is a more interesting and challenging place to work
- 27. The public sector's working environment is more professional

2) Calculation of the average value of each statement and factor in each respective country ($\bar{x}_{ij}$ and $\bar{w}_{ij}$);

3) The average values of statements are weighted using significance factors as coefficients that show how important these factors are for youth ($\bar{x}_{ij} * \bar{w}_{ij}$). This result is divided by 10 in order to stay in the same estimation scale that is used throughout the questionnaire.

Example: the statement „*Career opportunities in public administration are less limited than in the private sector*" (questionnaire`s question No.22) is evaluated with an average value of 4,57 in Estonia, 4,621 in Latvia, 4,358 in Lithuania and 3,850 in Germany. Then it is necessary to evaluate how important participant rates the *career opportunity* itself (questionnaire`s question No.31) – it is evaluated with an average value of 8,411 in Estonia, 8,738 in Latvia, 8,642 in Lithuania and 8,150 in Germany. Then the average value of the statement is multiplied by the average value of its respective significance coefficient and divided by the maximum of estimation scale (10) as a result more unbiased weighted estimation is calculated. For some factors there are no weighing coefficients since their importance or significance is unquestionable, e.g., it is assumed that bad experience or opinion, or sense of responsibility needs no significance coefficient. In this case the maximum of evaluation scale (10) is used in order to have the same average value of statement after it is divided by 10.

N.B. It is important at this stage not to calculate the overall average value of all previous average evaluations since among 18 factors there are five dissuading factors to which inverse interpretation of the evaluation scale applies (1 being better and 10 being worse). And because of inequality of amount of "positive" and "negative" factors the overall evaluation is influenced just by the number of factors, but not by factors` factual essence. Besides, because of influence of inverse scale of dissuading factors, the maximum possible overall evaluation using this method of calculation in a perfect scenario would be seemingly random number 7,500.

4) Weighted evaluations of motivating and comparative factors are divided by their maximum possible value ($max_i = 10$). Since the evaluation scale inverses for dissuading factors and the best possible value for these factors is "1", then 1 is divided by the weighted evaluations of for dissuading factors to calculate their share in maximum possible value. All shares are expressed per cents. Now we have evaluations based on maximum possible values for each statement (F_{ij}).

5) And for the last calculation step the overall public administration`s attractiveness indicator for respective country is calculated as an average value of all sub-indicators ($\bar{F}_j = \frac{\sum F_{ij}}{n_i}$).

Since the opinion of the most and the least attractive public administrations might have already formed from previous analyses, the results of overall public administration`s attractiveness indicator calculations showed no huge surprise in these terms. With an overall indicator of 45,1%, the most attractive public administration in perception of respective country`s youth is Estonia – 11 out of 18 given statements are evaluated the most positively for Estonian public administration in comparison to other countries. From previous analyses it might seem that the second most attractive public administration overall would be Germany where youth evaluations on state related factors in 4 cases ranked 1st and in 3 cases ranked 2nd, while Lithuania`s youth evaluations were never ranked neither 1st nor last, but always 2nd (10 statements) and 3rd (8 statements), as a result second most attractive public administration overall is Lithuania with indicator of 43,2%. It is to be admitted though that Germany ranks 3rd with only 0,4%-point difference – 42,8%. And the lowest overall indicator (40,6%) is in Latvia where 12 out of 18 given statements are evaluated the least positively for public administration in comparison to other countries and in 3 factors Latvia was ranked the 1st – the highest agreement that there are better career opportunities and higher salary in public administration institutions as well as considering that a job in public administration is easier, simpler and takes less effort than in the private sector (See Table 5).

Table 5. Overall public administration`s attractiveness indicator from youth perspective

Statements	Weighing significance factors	The share of weighted evaluation of statement in its maximum (F_i)			
		EE	LV	LT	DE
2. I consider myself as the future of my country		75,3%	78,5%	75,8%	79,5%
3. I would like to work in a national or local government institution		65,8%	56,7%	58,8%	58,8%
9. I would consider running for government or parliament elections		47,9%	35,7%	46,6%	44,8%
11. I have a sense of responsibility towards my country		76,1%	64,0%	76,0%	75,3%
12. I feel that I could be helpful in public administration		70,5%	62,2%	69,9%	68,7%
13. I have my own opinion, which I would like to implement		67,9%	61,8%	65,5%	64,7%
15. I have no interest in public administration	32. It is important that job is interesting and challenging for me	32,8%	27,1%	33,7%	34,3%
16. I do not believe that I can change anything in public administration		24,6%	19,0%	24,2%	24,4%
17. I have a bad opinion of public administration		23,3%	14,5%	17,2%	21,7%
18. I have a bad experience in dealing with public administration		25,4%	18,4%	19,0%	21,7%
19. Working in public administration is not prestigious	30. Prestige	37,4%	30,7%	35,6%	32,9%
21. A job in public administration, including salary, is more guaranteed		65,6%	64,4%	64,8%	75,2%
22. Career opportunities in public administration are less limited	31. Career opportunities	38,4%	40,4%	37,7%	31,4%
23. A job in public administration is easier and takes less effort	34. Job can be easily accomplished	19,6%	28,3%	24,3%	15,9%
24. Taking initiative is more appreciated in the public sector than in the private sector	35. Leaders encourage initiative and appreciate work	36,0%	31,1%	30,3%	36,3%
25. Salaries in public administration are higher than in the private sector	29. Salary	28,3%	36,7%	33,5%	26,7%
26. The public sector is a more interesting and challenging place to work	32. It is important that job is interesting and challenging for me	40,4%	33,7%	36,8%	35,5%
27. The public sector's working environment is more professional	33. Professional leaders, rational decision making	36,8%	28,5%	28,0%	23,4%
Average public administration`s attractiveness indicator		**45,1%**	**40,6%**	**43,2%**	**42,8%**

Source: author`s research results

Methodology of the calculation of indicators allows for the comparison of results not only among countries thus identifying the practises to learn from other countries, but also to show the share of a specific country`s indicators in its own maximum, thus a particular country can look up not only to those higher levels of performance of other countries, but also can strive for its own excellence.

Conclusion

In conclusion, firstly, gratitude is paid to all participants of the research as well as the academic supervisor, experts and consultants that believed in, encouraged, supported and helped with the research. Due to the article's length restrictions, the essay contains only main results, charts and trends. More detailed and comprehensive anatomy of the research is available upon request at author`s e-mail.

Main content-based conclusions

- Most popular areas for participation in public administration development are private sector, NGOs and state institutions.
- The situation of youth's willingness and intentions to participating in public administration development are quite different among countries, for instance, in Estonia they find working for public administration much more appealing than in Latvia and Germany. Lithuanian public administration is also quite appealing for young people. Almost 70% of young people in Estonia and a little over 50% of young Lithuanians showed interest in working in national or local government institution, but only 33% of young Latvians and 44% of German youth showed similar interest.

- In all Baltic countries there are more people having bad opinions of public administration than those having bad experience. In Latvia the difference is significantly higher than in other countries. This might lead to a thought of public communication issues (PR campaigns, news) that is obviously a better practice in Germany where the difference is even in favour of good opinion despite the fact the experience is worse.
- Lower salaries, less professional working environment, worse recognition from managers are factors that keep public administrations less attractive to youth.
- Estonia once again proved itself with overall better results of youth attitude towards public administration, which, taking into account Estonia's socio-economic development, is a good signal for other countries to search for best practises and perform deeper and more substantial researches of their clients as well as to take actions in order to increase client satisfaction importance of which has been presented in the article
- The results of the research may be used for national strategic planning, namely for planning activities to increase the attractiveness of the public administration and generally society`s level of satisfaction with public administration performance. The results also serve as the background for further and deeper researches.

Organizational conclusions

- Before launching the research, the questionnaire was tested on 50 experts, who gave suggestions and improvements on both design and content of the questionnaire and research, which in its turn gave the author a „test-drive" of the research and an opportunity to plan the research results` analyses more detailed and more successful. „Failing to prepare is preparing to fail." /John Robert Wooden. American basketball player and coach./ Good preparation had lot of benefits.
- One of the substantial research restrictions was finances. The average price for data collection at a sufficient amount, if it was outsourced to professional research company, would vary around 1`500 euros per country (data collection for 4 countries covered in this research would cost around 6`000 euros); the average price for whole research with the primary overall analyses would cost nearly 20`000 euros. It took unexpectedly long time and effort for author to collect and analyse data on his own.

  Although academia often might not have the direct impact on initiating changes in public administration, it can certainly reveal the impact on general public opinion. Keeping that in mind and also taking into account that society, its opinion and demand is actually the main basis of development of public policies, author believes that academic activities and achievements will indirectly (through changing public opinion) will give a hand in diminishing the gap between what science knows and what business does.

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The Role of Trade Unions in Social Dialog and Social Agreements in New Member States: the Case of Latvia

1. Introduction

Most of the European Union Member States were seriously affected by the economic, financial and social crises of 2008-2009, consequences of which continue to be felt particularly in the social area. The socio- economic situation experienced serious negative changes that threaten social cohesion in Europe. The European Commission Joint Employment Report 2009/2010 to the Council[1] calls for measures to be taken to ensure social stability in the EU. The report describes the employment situation in 2008-2009 and provides an outlook to 2011. Despite signs of economic recovery in the EU, employment prospects remain unfavourable.

Some of the EU Member States have been hit more seriously then the others. One of these countiries is Latvia, belonging to the group of the New Member States (NMS). Latvia entred the EU in 2004 and during 2004-2007, had the fastest GDP growth in the EU (2004- 10.4%; 2006- 11.9%; 2007- 10, 2%). However, the severe economic downturn severely affected the growth tendency in 2008[2].

The reasons for the earlier unusual economic growth were largely due to a substantial inflow of foreign capital, which stimulated domestic demand based on easy credit conditions and an expansionary fiscal stance. The economic crisis originated in the reversal of the domestic real estate boom and worsened rapidly when risk aversion became extreme on global financial markets. In the first half of 2008, real GDP contracted by 4.6%[3]. In 2009, GDP had fallen by 18.7%. According to the the Ministry of Economy towards the end of the 2010 Latvia managed to overcome the recession, and in 2011 started a slow recovery. Analysts expressly predict a 3,3% GDP growth in 2011.[4]

The economic downturn in Latvia was accompanied by raising unemployment, with the labour market significantly deterioreting since the end of 2008. The lowest point was reached in the first quarter of 2010 when the employment rate shrank to 57.7% (population aged 15-64 years), and the unemployment rate of the population aged 15-74, increased to 20.4%.[5] The decrease of the employment rate as well as the decrease in the level of wages due to the economic recession are the main push factors for out-migration of the labour force creating dangerous structural problems in the Latvian economy. The outflows of labour and especially of high skilled professionals negatively influenced the potential for economic recovery and sustainability of the welfare system.

Significant budget consolidation measures have been taken to implement the cumulative fiscal adjustment in 2009-2010 in the amount of 10.5% of GDP. The government reduced public spending and budget deficit by 500 M LVL (EUR 711.4 M)," in 2009 and by LVL 250 M (EUR 355.7 M), in 2010. Currently the budget deficit is at 8.5%.[6] Additional cuts to public spending are foreseen in 2011. This trend will increase the number of unemployed people and the subsequent reduction in demand will result in further staff cuts in the private sector.[7] According to the EU Lisbon Strategy "Europe 2020", the aim should be to reach an employment level of 75% for the 20 to 64 age group; currently in Latvia this percentage is only around 58%[8]. A gradual decrease of unemployment is expected only in 2011.

At a time when Latvia is slowly recovering from the economic resession, and in particular, from a fall in production and

[1] European Commission (2009) Draft Report from the Commission to the Council "Draft Joint Employment Report (JER)" 2009/2010. COM(2009)674/3. Brussels
[2]Eurostat. Flash Estimate 14 February 2008.
[3]EC European Economy no 32009 May 4, 2009.
(http://ec.europa.eu/economy_finance/pdf/2009/springforecasts/lv.html) 12/03/111
[4] The National Economy of Latvia. LR Ministry of Economy Report December 2010.
(http://www.em.gov.lv/images/modules/items/tsdep/zin_2010_2/2010_dec_eng.pdf) 12/03/11
[5]LR Ministry of Economy. Report June 2010.
[6]LR CSB.
[7]Unemployment situation complicates an additional phenomenon. With the requirement of the EC and IMF to cut the budget expenditure, the government, ministries and other public institutions are reducing a number of employees in public sector that is resulted in high unemployment of public servants and other groups of employees in different areas of the public sector located in Riga and major cities in the country.
[8]Latvian National Employment Agency.

increase in unemployment, a swift and desicive response by the government is essential. The Latvian government has determined certain activities to pursue strict and stable monetary policy and to stabilize state's financial system. Nevertheless, it would be particularly important to coordinate financial system support measures with active labour market policies, in order to mitigate structural long-term unemployment and to avoid social tensions. There is a possible development of social unrest related to the economic recesion and the deteriorating labour market requires strategic actions.

2. Legislation development on employment policy and social dialogue

To tackle unemployment and pursue active labour market policies, there is a need for fundamental change and the further implementation of the European Union's strategy for jobs and smart, sustainable and inclusive growth (Europe 2020)[9] and European Employment Strategy (EES). The European Employment Strategy was launched in 1997[10] to encourage the exchange of information and joint discussions by all Member States with the involvement of social partners, the European Parliament, European Economic and Social Committee, and the Committee of Regions in the social dialogue. The EES is intended as the main instrument to provide, through the open method of coordination, direction and to coordinate the employment policy priorities supported by the Member States at the European level. Employment policy in the European Union incorporates labour law and occupational health and safety, as well as gender mainstreaming. It also sets standards and objectives in these areas, as well as laying down the principles of anti-discrimination policy. The European Union has no powers to harmonise the numerous,and in some cases very different, systems of social protection and employment policies in the Member States.Rather., its role is to coordinate these systems in order to protect the main principles of the Common Market. The European Social Charter articulates a number of fundamental rights in such areas as collective bargaining, protection from unjustified dismissal, health and safety at work, etc.[11]

When Latvia regained independence in 1991, the legal labour relations system was based on the Labour Code adopted in 1972. A labour law reform was needed and it was launched in the 1990s and the new Labour Law is in force since 1 June 2002. The major part of this reform process was the implementation of rules stemming from international laws, and in particular, EU laws. Despite the fact that Latvian legislation does not give an explicit definition of the term 'employer-employee relationship', a number of international agreements on human rights, welfare, and social protection have been signed and to regulate labour relations. Latvia has ratified a number of the International Labour Organization's Conventions.[12]

For example, the Law "On Trade Unions" was addopted on 13 December 1990. The Law provides that trade unions may be formed on the basis of professional, branch, territorial or other principles. Employers shall also be entitled to form associations. The most widespread patterns in practice are the branch, undertaking and professional trade unions. The Law insures the right to join a union or also not joining or withdrawing from a union (so-called negative right). According to the Law property and financial relations between trade unions and the employer shall be governed by law, collective agreements and other types of agreements. In most cases the relations of a trade union and employer are regulated by collective agreements.

As a result of the labour law reform a new framework for national consultaion was established. The status of a social partner and a social dialogue are regulated by the law "On Employers' Organisations and their Associations" (29 April 1999), and the law "On Collective Labour Agreements" (26 March 1999). These legal documents are in line with EU principles on social dialogue and social partnerships. In addition, the trilateral consultation mechanism between government representatives, the largest employers' and trade union organisations - the Latvian Employers' Confederation and the Free Trade Union Federation of Latvia was launched. The National Tripartite Co-operation

[9] Europe 2020 (http://ec.europa.eu/europe2020/index_en.htm) 20/04/11
[10] Community Policy in Support of Employment. Communication from the Commission. No D/98/9.
[11] European Social Charter, Council of Europe Treaty, adopted in 1961, revised in 1996, (http://www.hrcr.org/docs/Social_Charter/soccharter.wpd) 15/04/11.
[12] C 87 "Convention Concerning Freedom of Association and Protection of the Right to Organise" (4 May 1990), C 98 "The Right to Organise and Collective Bargaining" (4 May 1990) and C 144 "Convention Concerning Tripartite Consultations to Promote the Implementation of International Labour Standards" (5 July 1994).

Council and its institutions – the Sub-council for Vocational Education and Employment, the Sub-council for Labour Matters, and the Social Insurance Sub-council aimed at promoting cooperation between the social partners at national level. This institutionalization of the social dialogue helps to find a framework for agreements between all social partners in solving social and economic problems. Such framework also increases responsibility of social partners in desision-makind process. Starting from 1996, the Free Trade Union Federation of Latvia and the Latvian Employers' Confederation are obliged to annually sign a bilateral social partnership agreement. The agreement allows both institutions to agree, for example, on the conditions related to level of the minimum salary level. Furthermore, labour disputes are regulated by the Labour Code of Latvia (1 January 2001), the law "On Collective Labour Agreements" (26 March 1999), the law "On Strikes" (23 April 1998), the Civil Procedure Law (1 March 1999) and the law "On Labour Protection" (4 May 1993).[13]

Latvia accepted and implemented in full the *aquis communautare* in the area of social policy and employment before its accession to the EU on 1 January 2003. During the process of accession negotiations, the position of Latvia on social protection and employment policy has been developed as the result of a mutual agreement between the government and the social partners – Free Trade Union Federation of Latvia and the Latvian Employers' Confederation.

In addition, the accession period required the design and implementation of the National Employment Plan (2004) that was launched in line with the Single National Economy Strategy (2004-2006). The Ministry of Welfare has issued two important strategy documents: the "Conception of the Development of labour protection from 2007-2010" and "The Programme for Development of Labour Protection from 2007-2010". Unfortunately, this process was not always systematic, as it was frequently demand-driven.

3. Identity of Trade Union movement in Latvia

To better understand the Latvian trade union movement, its structure, policies, practices, as well as its effectiveness, - a historical profile of the formation and development of the trade unions movement are of prime importance.

Trade union organisations are different in the EU Member States. The identity and performance of trade unions depend on the existing trends in politics, labour markets and social structures. The following major models of trade unions could be considered:

1. Welfare trade unions mostly function in France, Italy and Spain.
2. Business trade unions, that represents employees' interests. The best examples of that type of trade unions could be found in North America.
3. Social partner unionisms, when trade unions are aimed at harmonisation of employees and social partners' positions. Such unions are in Scandinavian countries as well as in the Netherlands and Germany.
4. Trade union movement in which a state plays a decisive role in shaping the parameters of trade unions practice. This particular model function in most of the New Member States.

The evolution of trade unions' identity in Latvia is rooted in the transformation process from the socialist system to a market economy system and reflects responses to social and political changes that the country has undergone during its last 20 years of independence. As a result, trade unions in Latvia are in transition from the model in which a state plays a dominant role to a model of social partner unionism, which is in common in other countries that were formerly part of the Soviet Union's trade union system. Decentralisation in 1991 left basic trade union organisations maintaining the one-workplace-one-union principle. Trade Unions in Latvia remain dominant within the trade union landscape, maintain the same organizing principles, namely branch unions, which adds up to a large measure of continuity. In contrast to unions' structure, unions' membership has changed dramatically. Trade union membership in Latvia declined dramatically since the early 1990s. Overall, only around 16% of employees are members of trade unions.

[13] Matters related to the social dialogue are also regulated by Article 108 of the Constitution of the Republic of Latvia (freedom of association and the protection of trade union rights), by the Law "On Strikes" (23 April 1998), and the Law "On Labour Protection" (4 May 1993).

During recent years the role of trade unions in many countries is becoming less important and visible. To different degrees all unions in the EU have seen a decline in their membership, resulting in an overall decline in union density. Such a trend could be explained by the following general reasons:

1. Globalisation and capital mobility are very powerful in influencing the negotiation process among major actors involved in the economic process and, thus, reducing the effectiveness of trade unions in collective negotiations.
2. Foreign investments have a strong impact on a policy of a state, which lowers the influeince of trade unions.
3. Trade unions' political participation, involvement in election campaigns, and strong links with political parties also reduce the importance of the membership in trade unions for current and potential members.

All of the above mentioned reasons for lowering the attractiveness of trade unions could be seen in Latvia. However, in addition to the explanations above, structural transforamation of the economic and political system in the country as well as in the organisational changes in the national economy strongly influenced this trend. The lack of a strong tradition of trade union activity following the experience of state socialism is another reason for the decline in membership.

Unions and membership in them are often considered as being a part of the socialst past, although in that period they were unable to perform their most imporatnt tasks, mainly providing collective representation and organising collective actions. At the same time the reasons for the decline in trade unions are not only the result of changes in the union environment, one should take into account also the strategic choices made by the unions themselves. In Latvia, for example, at the national level, one union confederation dominates. There is a single central trade union organisation – the Free Trade Union Federation of Latvia (LBAS).

Analysis of recent statistical data shows that the Latvian Free Trade Union Federation currently unites 21 trade unions. The proportion of employees that are members of unions is only 16% (according to the SCB in 2009, only 143,100 people out of an employed labour force of 953.900 were members of trade unions). Membership is higher in some areas of the public services – in general 33%, but in health and social work, and in education systems a membership could reach up to 60%, for example. [14] One of the important elements in employee-employer relations are collective agreements. In Latvia collective agreements cover around 20% of all employees, however, coverage is higher in the public services at around 55% in health and 90% in the electricity sector.[15]

Collective bargaining takes place mainly at the local, company level and in the public sector. There are some sectoral agreements, particularly in the public sector and various civil service and public companies – for example, energy and water suppliers and forestry. However, higher-level collective agreements are rather policy documents, dealing with issues in social partnership, than collective bargaining on employment conditions. The principal level of collective bargaining is at the company level. The framwork for collective bargauning was set out in laws passed in 1998 and 1999, as well as during the negotiations on the accession to the EU. The Latvian bargaining coverage is at the lower end of the scale At the beginning of the year 2003 there were 32 collective agreements concluded at a sectoral or branch level. Concluded sectoral agreements are very general and in majority of cases they just reproduce the possibilities offered by the law.

The dialogue at enterprise level is more common and better developed, especially in medium and large enterprises. According to the available, at the beginning of the year 2003, the total number of collective agreements amounted to 2368[16] The branch unions', particularly in the transport and public sector, make more frequent use strikes to achieve their objectives. Therefore, in order to understand the conditions under which organisations acquire success and strength, it is important to consider how trade unions, their leaders and employees interact.

[14] LR CSB
[15] European Federation of Public Service Unions (http://www.epsu.org/r/469)1/04/11
[16] Ministry of Welfare based on the information received from Latvian Free Trade Union Confederation in Social dialogue and conflict resolution in Latvia. European Foundation for the Improvement of Living and Working Conditions, 2004 (http://www.uni-mannheim.de/edz/pdf/ef/04/ef0450en.pdf) 1/04/11

To deal with these issues, questionnaires have been distributed to representatives of the Latvian Free Trade Union Federation, the Latvian Railway Workers Union (which functions in the state sector and has 16, 000 members), and to the Latvian Transit Workers Union (in the private sector with 1000 members). In addition to the above, the questionnaires cover a number of questions about employment policy in the country, strategic planning of employment policy at the company level, trade union policy related to potential increase of membership and on the role of trade unions in social dialogue (this question is particularly important in the light of the current economic recession).

On the basis of the analytical results of questionnaires distributed among representatives from the above mentioned trade unions, the following major conclusions could be summarised:

1. In general, employees in Latvia have opted for individual strategies rather than collective strategies to improve their economic situation. This trend weakens employees' collective identity.
2. Trade unions members' collective identity and participation are proportional to their feelings of importance in their organisation.
3. The interviews' results illustrated that the interviewees considered skilled leadership fundamental to Trade unions' success. And once the members of the organisation see concrete policy results by means of their participation, they will have more reasons to participate.
4. Trade union leaders rose up through the union hierarchy mostly through their cultural capital and expertise.
5. Overall the involvement of trade unions as well as the other social partners is not strong enough, despite some examples in which unions' voices were heard.

However, the position of the Latvian Free Trade Union Federation in the current economic situation has become more visible and stronger than in the past. Trade union leaders have criticised both tax changes and sectoral support measures and made their own proposals (together with other social partners), some of which have been accepted by the government. Trade union resistance prevented the introduction of some measures.

A number of protests had already been organised by trade unions against government decisions about state budget reduction for social protection in 2007, followed by protests in 2009[17]. Despite the substantial decline in membership, unions seem to have retained as strong voice on the national stage. As a result, the European Trade Union Confederation (ETUC) called for a new social deal across Europe that would provide an alternative to the neoliberal policies being proposed by governments in the NMS including Latvia, which had been hit by the crises.[18]

4. Social dialogue and flexicurity approach: the role of trade unions in employment policy

The crisis highlighted an urgent need to develop new policy responses to help provide social stability in the European Union and alleviate social hardship. Although labour markets deteriorated in the EU, unemployment was more prevalent in some countries than in others. It is important to stress that the countries with the most rigid labour market regulations have suffered the sharpest surge in unemployment numbers, indicating this is an important condition that should be considered alongside stimulus programmes. The European Commission Draft Joint Employment Report (JER)" 2009/2010 Report[19] reaches the conclusion that socio economic inequalities have increased in Europe. It argues that "a combination of factors (including economic restructuring associated with the move towards a knowledge economy, labor market change and redistributive policies of welfare states) account for these increases in inequality in the last two to three decades.

[17] 10, 000 people in Latvia joined the demonstration against Latvia government policies in January, 2009 and later in March, the trade union of Health and Social Care Employees of Latvia (LVSADA) organised a picket in the capital, calling for an increase in salaries and improvement of working conditions for social workers and women working in social care and assistance. The LVSADA has been negotiating with Riga City Council since November 2006 and has tried to reach a solution on decent salaries in the social care sector from January 2007. Unfortunately all the union's efforts of the union have been unsuccessful. A survey by the LVSADA revealed that 98% of employees in the social care sector in Riga are women and 49% of them are main breadwinners in their families. Our social workers are standing for social peace. Therefore, considering that inflation in Latvia is 7%, the LVSADA is calling on Riga City Council to make appropriate changes to the budget and increase the salaries of social workers by up to 20%.

[18] EPSU/CEMR-EP Joint statement to the European Council meeting 11 February 2010 on the economic crisis (http://www.epsu.org/a/62121) 4/0411

[19] European Commission (2009) Draft Report from the Commission to the Council "Draft Joint Employment Report (JER)" 2009/2010. COM(2009)674/3. Brussels

One of the key issues is the development of effective employment policy at the level of the EU as well as at the level of nation states and to ensure internal flexibility as the core to labour market stabilization.[20] A constructive social dialogue and decisive responses from all social partners are required to provide synergy between social and economic development, effective employment policy and a safety net for the future. A flexicurity approach[21] was thus established to conciliate employers' and workers' needs, flexibility and security, by ensuring the worker safe transitions inside the labour market, while maintaining and improving competitiveness of the companies and also preserving the European Social Model. Based on consultations with the Member States, international organisations, social partners and the academic community, the European Commission has suggested "pathways" and "common principles" in order to achieve flexicurity. [22] In the Integrated Guidelines, Member States are asked to promote flexibility combined with employment security — 'flexicurity' — and reduce labour market segmentation, having due regard to the role of social analysis and dialogue over choice is the foundation for the flexicurity approach and the introduction of flexicurity principles. The viability of these choices is largely dependent on the willingness and the ability of social partners to engage and define dialogue in setting up national employment policy. Flexicurity comprises activities aimed at promoting labour market flexibility and employment security by mutual interaction. It is necessary to ensure that labour legislation and agreements are sufficiently flexible and correspond to the interests of both parties – the employers and the employees. In the case of necessity, active labour market policy must efficiently facilitate the transfer from one workplace to another or from the status of an unemployed person to employment. The Spring European Council of 2009 recommends that Latvia enact an integrated flexicurity approach, to intensify efforts to increase labour supply and productivity by reinforcing activation measures and enhancing the responsiveness of education and training systems to labour market needs.[23]

To promote implementation of flexicurity principles in Latvia, on May 15, 2009, the Saeima adopted amendments to the Labour Law, which are also related to the flexibility and security in the context of employment relations.[24] The need to put into practice the aims of the Lisbon Strategy and principles of flexicurity in Latvia requires ensuring effective social dialogue between the Employers' Confederation of Latvia, the Free Trade Union Federation and the government. Development of such a trend still is not included in national programmes on a large scale and does not have strong government support. Several measures have been implemented in recent years for the improvement of the social dialogue, both on the national and local levels. For example, with the help of European Social Fund financing, the social partners involved in employment partnership, include the Employers' Confederation of Latvia and the Free Trade Union Federation of Latvia, local governments and the Latvian Association of Local and Regional Governments. This partnership ensures social dialogue at the local and regional level and increases participation opportunities of social partners in the decision-making process and provision of public services. In addition, the partnership facilitates quality improvement of public services provided by non-governmental organisations. [25]

[20]Baltic Rim Economies: Growth and Constrains 2010, Published by the DnBNORD: a number of EU countries have attempted to battle labour market rigidity. For example, Germany introduced work-sharing schemes, under which wages are compensated for shorter hours. Such schemes appear to be successful in upholding both employment and incomes in the more affluent states. It should be noted, however, that such programs are difficult to replicate in less prosperous countries. Among the three Baltic States, only Estonia has enhanced flexibility of labour market by introducing a new Employment Contracts Act, effective 1 July 2009, which shortened the lay-off notice and reduced severance payments. The new Act also allows distressed employers to cut salaries to the minimum wage for up to 3 months, and reduces bureaucratic barriers (for example, eliminating the need to gain the approval of a labour inspector when terminating employment con-tracts, or establishing part-time working hours).

[21] Flexicurity is the European labour market policy aimed at compensating the ongoing flexibilization of employment relations (deregulation of labour markets) by means of advantages in social security (Andranik Tangian, 2010). WP 2010.06.Not for bad weather: macroanalysis of flexicurity with regard to the crisis, ETUI, Brussels, 2010-53 pp.

[22]Flexicurity Pathways. Turning hurdles into stepping stones, June 2007, Report by the European Expert Group on Flexicurity. (http://ec.europa.eu/social/main.jsp?catId=117&langId=en)1/03/11 .

[23]Report on Progress in Implementation of the National Lisbon Programme of Latvia (http://ec.europa.eu/archives/growthandjobs_2009/pdf/nrp2009/lv_nrp_en.pdf)12/03/2011

[24] Labour Law amended (http://wwwlikumdosana_kart_rullis.html.saeima.lv/Likumdosana_eng)/12/03/11

[25] Report on Progress in Implementation of the National Lisbon Programme of Latvia, pp 41-42 (http://ec.europa.eu/archives/growthandjobs_2009/pdf/nrp2009/lv_nrp_en.pdf)12/03/2011

A constructive social dialogue and decisive response from all social partners are required to provide synergies between social and economic development, effective employment policy and a safety net for the future. [26]

5. The Lisbon Treaty and the European Citizen initiative a new opportunity for trade unions

The Lisbon Treaty give the citizens a golden opportunity to participate directly the future shaping of the EU. While in many countries there are various types of citizens' initiatives (from petions to referenda) this seems to be the first time in contemporary history, that such an opportunity is offered to citizens at a multinational level, that of the European Union. In terms of artical 11, parahraph 4 of the Lisbon Treaty, "Not less than one million citizens who are nationals of a significunt number of Member States may take the initiative of inviting the European Commission, which the framework of its powers, to submit any appropriate proposal on matters where citizens consider that a legal act of the Union is required for the purpose of implementing the Treaties".[27]

The question of what is meant by a "significunt number of Member States" was debated at length. Civil society organisations argued that the number should be not too high because many Europan issues have a regional character. The European Commission opted for one-third of Memebr States. The support of the European Parliament related to this initiative is shown, in particular, by the fact that European Parliament at the begining considered this initiative as possibly encrouching on its prorogative. It set up a group of 4 raporters from all the major political groups (a very unusual procedure) to prepare the Paliament's position on this initiative. In the end, it produced a document strongly supportive of this initiative, for example by reducing the number of Member States required to partivpate from one third as proposed by the Commision to one quater.

There was, though, no change in the minimum number of signitures for each state (the number of MEPs by country multiplied by 750, the total number of MEPs). As the result of the dabates, the European Parliament and European Council have addopted on 16 februaty 2011 Regulation No 211/2011[28] to ensure practical implementation of the artical 11 of the Lisbon Treaty.

The Regulation requires that for an initiative to be valid a minimum of one milion signatures from at least 7 Member States are needed the proportion of signitures in each of the member State being based on the number of the members of the European Parliamen. Concreatly this means that signitures must be collected in at least 7 Memebr States through appropriotely formed commitees. This is a major breakthough which trade unions should consider how to make best use to enhance the conditions of the workers throught the EU.

Trade unions exist in all Member States and still have considerable membership, and this despite the reduction of membership numbers. Trade unions can therefore be a driving force for requesting the European Commission to introduce initiatives to further improve working conditions of the workers. The trade unions should consider to overcome there ideological diferences in their identities to take a real advantage of this opportunity. This would increase their value and attractiveness for thir members and for the labour force in the European Union in general and consequently revitalise the trade unions movement in the EU.

Conclusion

At a time when Latvia is facing an economic downturn, a fall in production and growing unemployment, a swift and decisive government response is needed. The dramatic current economic situation requires fulfilling a dual task: maintaining the long-term goals of Latvia's social policies and responding to economic and social challenges. It would be particularly important to coordinate financial system support measures with active labour market policies in order to

[26] According to the Ministry of Economy, changes in the labour market for a timely balancing of the labour market demand and supply create necessity to develop a labour market forecasting system. The Ministry of Economy is responsible for coordination of medium and long-term labour market forecasting in the country. The ministry also works out labour market development scenarios, as well as medium and long-term forecasts. Under the Ministry of Economics, the Advisory Council of the Labour Market Forecasting is operating, which comprises representatives from the involved institutions and social partners. The task of the Council is to ensure inter-institutional cooperation by assessing the prepared forecasts and seeking solutions for further action.(http://ec.europa.eu/archives/growthandjobs_2009/pdf/nrp2009/lv_nrp_en.pdf)12/03/2011

[27] Treaty of Lisbon amending the Treaty on European Union and the Treaty established the European Community, signed at Lisbon 13, December 2007, Official Journal of the European Union, C 306 Volume 50, 17 December 2007.

[28] Regulation (EU N0 211/2011 of the European Parliament and of the Council of 16 February 2011.

mitigate structural long-term unemployment and to avoid social tensions. There is a possible development of social unrest with further GDP decline: a looming social crisis. The deteriorating labour market requires immediate action.

A number of international agreements on human rights, welfare, and social protection have been signed to regulate labour relations. Unfortunately however, this process was not always systematic, as it was frequently demand-driven. The results of this study show that the trade union movement has a relatively short history in Latvia and followed the legacy of transformation to a market economy as a result of regained independence. The trade unions in Latvia are in a transition process from the model in which the state plays a dominant role to a model of social partner unionism.

The involvement of trade unions as well as other social partners in social dialogue and decision-making in Latvia is not strong enough, despite some examples in which unions' voices were heard. However, the position of the Latvian Free Trade Union Federation in the current economic situation has become more visible andgrown in strength over the years.. Trade union leaders have criticised both tax changes and sectoral support measures and made their own proposals (together with the other social partners), some of which have been accepted by the government. Trade union resistance prevented the introduction of some measures.

A constructive social dialogue and decisive response from all social partners over choices in development of a flexicurity approach and introducing flexicurity principles is required. The viability of these choices is largely dependent on the willingness and the ability of social partners to engage and define dialogue in setting up a national employment policy.

The decision-making process should include the government's willingness to learn from the experiences of other countries that have undergone economic crises and successfully reformed their employment policies. Improved governance, transparency and involvement of stakeholders in social dialogue are essential to strengthen the links between economic development and effective employment policies. Finally the collective engagement of trade unions in using the opportunity offered by the provision of the Lisbon Treaty by the "European Citizen's Initiatives" should not be missed by the trade unions to both enhance their value to their membership and revitalize their image.

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A Baltic Tiger in the Poorhouse – A Schumpeterian View of the Baltic Crisis

I Introduction

After regaining independence in 1991, the Baltic States launched an economic strategy that might be called "a laboratory of liberalization." "The Baltic states became poster boys of the Washington Consensus" (Kattel 2009, p. 1). In the case of Estonia, for example, the government put forward radical reforms to stimulate prosperity. These included a sound currency, a balanced budget, the cutting of subsidies to state-owned companies, property reform in connection with privatization, the elimination of tariff and non-tariff trade barriers, and a reform of the tax system (first simple flat tax in the world). Consequently, in the 2007 Index of Economic Freedom Estonia shows up as the twelfth freest economy in the world.

Until the beginning of the financial crisis, the results of this experiment have been remarkable: an 8% average annual GDP growth since 2000, a strong decrease of poverty and inequality, and low unemployment and inflation rates. To sum it up, living standards improved rapidly, which might be seen as the best proof of a successful strategy. However, the financial crisis hit the Baltic States very hard; GDP in Estonia fell by 3.6% in 2008 and a further 14.1% in 2009. The unemployment rate was at 18.6% during the second quarter of 2010. Who can be blamed for this sudden growth breakdown? Government? Globalization? Wall Street? Or does the rise and fall of the Baltic states – seen from a long-term perspective – reflect a natural development in terms of business cycles theory, something that occurs as a "small blip in an otherwise unstoppable upward" (Kattel 2009, p. 1)?

This paper shows that the Baltic States' rise and fall can be interpreted from a broad Schumpeterian perspective, which includes the role of entrepreneurs, the combination of innovation and money within a free trade doctrine, and the role of the state (Schumpeter 1939). In other words, we like to answer Kattel's question (2009, p. 1) regarding whether this laboratory of liberalism "was based on fundamental misunderstandings and that this model was bound to create enormous fragility for the Balitic States, with or without a global financial meltdown."

II A Schumpeterian Perspective on the Crisis

1. Economic Change, Business Cycles, and the Crisis of Capitalism

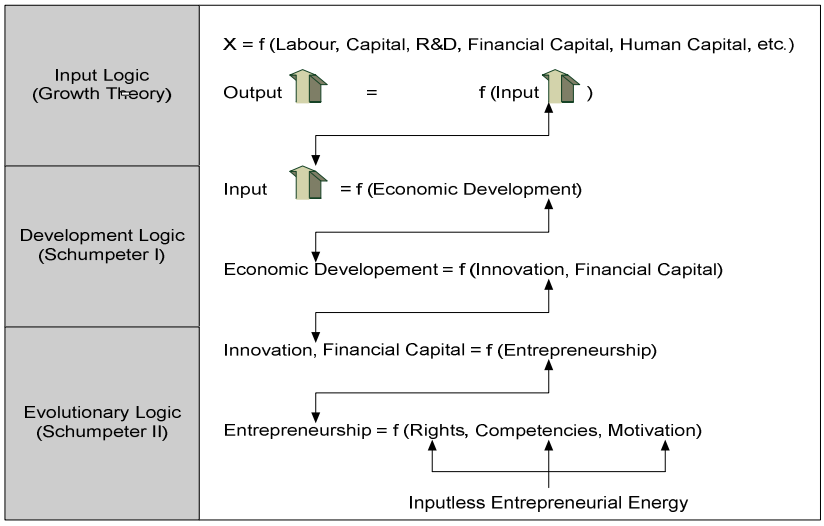
According to Schumpeter, innovation represents the fundamental factor in the economic history of capitalism; only innovative change can result in economic development (Schumpeter 1939, pp. 84). The term "innovation" covers the following five cases: creation of a new good, introduction of a new production method, the opening up of new markets, the conquest of a new source of supply, and the introduction of a new form of organization (Schumpeter 1934/2002, pp. 66). The introduction of innovation is a function of the dynamic entrepreneur, whose term and name are connected 'only to those who actually perfom that function' (Schumpeter 1934/2002, pp. 75).[1] Nevertheless, Schumpeter argued that the introduction of something "new" involves three types of problems: first, the resistance of the environment, second, a preference for familiar behavior, and third, general fear of the unknown ("uncertainty" in terms of Knight), which is why not everyone introduces something "new" and becomes an economic forerunner (Schumpeter 1939, pp. 99). Should an entrepreneur, who is to be strictly distinguished from an inventor or investor, succeed in introducing his innovation onto the market (or into politics), this would disturb the existing equilibrium in economic life, triggering overall structural change.

Additionally, the Schumpeterian approach contains a fruitful relationship between the innovation process and the financial sphere of "credit drawing bankers." We now know that the banking system has lost some of its capabilities, which Schumpeter had seen in financial entrepreneurs like Crédit Mobilier or John Law, thus informal systems of business angels and bootstrappers are responsible for financing the bulk of entrepreneurs, thereby paving the way of formal financing systems (Siemon 2006). Schumpeter differentiated between innovative entrepreneurs („combining

[1] For more on the functionalist interpretation of entrepreneurial behavior from a newer, evolutionary perspective, see Röpke 2002.

given factors new“) vs. routine entrepreneurs („reproducing the same;“ „mere managers“) and claimed that basic innovations are needed to enter the dynamics of a Kondratieff wave (“Techno Economic Paradigms” in terms of Schumpeter’s followers like Perez or Freeman). The microeconomic basis for explaining innovative/entrepreneurial behaviour refers to an evolutionary economic approach containing the analysis of an interplay of three variables of action: property rights, competencies, and motivation. An entrepreneur has to be allowed, able, and willing to act innovative (see figure 1). [2]

Figure 1: On the connection of Input, Development, and Evolutionary Logic



Source: Siemon (2009, p. 22)

Schumpeter’s theory of business cycles is an integrative part of his theory of economic development and should not be analyzed isolated. Schumpeter claimed that innovations trigger economic cycles whose cycle duration depends on the nature and significance of the innovation. Thereby originally “connecting the economic cycle directly with the innovations, which Schumpeter assumed appeared in discontinuous ‘waves’ or ‘clusters,’ creating the trigger for economic development (Oakley 1990, p. 168). The process and explanation of the economic cycle includes the following steps (Schumpeter 1934/2002, pp. 61; Mütze 1990, pp. 34; Ritter-Thiele 1992, pp. 83): the starting point presumes an equally balanced economic situation. The introduction of the new combination can be seen as the first sign of recovery and leads to a rise in capital investment in the investment goods industry, whereby the innovator must first withdraw the necessary production factors from their old applications via credit. The change of the economic production structure between old and new business is thus steered by means of the factor allocation, i.e. by means of relative prices. Economic recovery then begins when the innovations accumulate and dynamic entrepreneurs appear in droves (“scharenweise”). This recurring disruption of the balance primarily has three causes: a rise in the price of the means of producers’ goods, a collapse in consumer goods, and a subsequent credit deflation process. The slump in consumer goods already marks the end of the recovery; prosperity already induces to some extent the period of liquidation. What follows is the phase of recession, which is marked by “the economic system’s struggling towards a new equilibrium position, its adaption to the data as altered by the disturbance of the boom” (Schumpeter 1934/2002, p. 231). The alternatives which remain for the ‘old’ businesses are to exit the market, to try and survive as a so-called marginal supplier, or to adapt by imitating the innovation. The process as a whole, however, progresses uninterrupted – in the sense that either revolution or absorption of the results of the revolution are always in progress; both together form what is known as economic cycle.

Regarding crisis theory, these proposals need to be expanded with respect to the effects of a secondary wave. While the innovation induced recovery triggers a primary wave, which spreads across the system of relative prices, thereby influencing the entire economy, the process similarly leads to the old businesses reacting to and/or speculating on the

[2] Even in methodological terms, Schumpeter changed his view. For more details see Meyer 2002 and Siemon 2008. For an evolutionary interpretation of Schumpeter’s views, see Röpke 1977. On the contrast of input, development, and evolutionary logic approach, see Röpke 2002.

new situation. Due to a surge in demand, which goes hand in hand with the creation of purchasing power, the second wave is triggererd. Only because of new purchasing power goes in bulk from the hands of entrepreneurs to the owners of material means of production, to all producers of goods for 'reproductive consumption' (Spiethoff), and to the workers, and then oozes into every economic channel, are all existing consumption goods finally sold at ever-rising prices. (…) And only on this account do production and trade *everywhere* temporarily yield a profit, just as in a period of inflation' (Schumpeter 1934/2002, p. 227). Characteristic of the secondary wave is the fact that the speculative anticipation of prosperity develops its own dynamics, leading to a spread in loans amongst businesses as well as privately. "In the atmosphere of secondary prosperity there will also develop reckless, fraudulent, or otherwise unseuccessful enterprise, which cannot stand the tests administered by recession" (Schumpeter 1939, p. 157). Under the pressure of the crash of the secondary wave, together with the related pessimistic expectations of economy's individuals, the economic system can shoot beyond the 'normal' equilibrium so that the aforementioned innovation cycle expands from prosperity and recession to include the phases of depression and recovery. Recovery results from the freeing up of market share and sinking prices for production factors.[3]

2. Social Change, Institutional Order, and the Crisis of Capitalism

In his most recent and commercially successful book "Capitalism, Socialism and Democracy" (Schumpeter 1942/2008) Schumpeter, three years after the appearance of "Business Cycles," conducted a comprehensive interdisciplinary analysis of the entire capitalist system. His approach reminds us of the political economy of Marx, adding political and sociological components to the aforementioned development and economic theories. He thereby highlighted, in particular, the significance of the institutional dimension of economic life; in new institutional economics terms, property and contract rights as well as the influence of social and political institutions play a central role for the development process of capitalism. Its prognosed "collapse" results, however, is not the result of pure economic reasons, but is the result of a changed social structure, which has grave repercussions on the economic system. To paraphrase one of Schumpeter's terms, one could speak of capitalist institutions also being 'creatively destroyed.' The stability (feudal elements) of the bourgeois society is eroding: 'With every peg from under the capitalist structure vanishes an impossibility of the socialist plan" (Schumpeter 1942/2008, p. 162). This process seems to be caused mainly by three interrelated reasons (Schumpeter 1942/2008, pp. 131). These hypotheses are analyzed below, whereby we will confront Schumpeter`s arguments with some opposite socioeconomic facts.

Hypothesis 1: The obsolescence of the entrepreneurial function

Schumpeter`s first thesis has led to a familiar controversy in economics about the relationship between competition and innovation (cp. Cohen/Levin 1989). The view usually associated with Schumpeter argues that monopolies might favor innovation; the opposite view (often associated with K. Arrow) argues that competition favors innovation. Following the advance of economic and social development, the social function of entrepreneurship in terms of 'getting things done' is losing significance. The resistance of the environment towards new developments has diminished substantially as well as the need to have a strong personality to introduce a new combination. Large businesses increasingly have the potential for internal financing to fulfill the investment needs of a new combination so that the function of capitalist (bankers) also diminishes. Overall these tendencies lead to a reduction in innovation dynamics. These two theses of Schumpeter subsequently led to repeated discussions on the end of entrepreneurship (see Horowitz 1962; Mansfield 1968; Bozeman/Link 1983; Mukhopadhyay 1985). These so-called Neo-Schumpeter hypotheses claim that, first, company size and the innovation power of a company are positively correlated; and, second, a higher market concentration promotes innovation. Both hypotheses could, however, not be empirically proven (cp. Cohen/Levin 1989).

[3] The Russian economist Kondratieff also assumed that the dynamics of economic life in a capitalist society were not ordinary/common and linear but 'complex and cyclical in character' (Kondratieff 1926, p. 573; our translation). Schumpeter refers in his "Business Cycles" explicitly to Kondratieff's empirical works and named the waves of the 50s and 60s triggered by basis innovation after the 'Kondratieff Waves'.

Hypothesis 2: The destruction of the protective strata

In the course of advancing capitalist development, innovative progress increasingly becomes a routine task conducted by large scale enterprises; in the words of Schumpeter, innovation becomes a mere issue of 'cost calculations.' Just as capitalism destroyed the structures of feudal society, increasing economic concentration is now destroying the 'old' capitalist economic and social structure. From this viewpoint, small and medium sized enterprises are being increasingly ousted from the market; oligopoly and monopoly structures characterize most economic branches and sectors. The fall of central capitalist institutions is also related to the rise of large-scale enterprises and public limited companies: private property as well as freedom of contract are increasingly infringed within the course of these developments. In contrast to the classic entrepreneur, managers of modern public companies behave like bureaucrats.[4] The reduced entrepreneurial potential of society also leads to the fall of the bourgeoisie, who partly let themselves be supported by the success of the entrepreneurs, yet also ensure sociopolitical protection and defend the political interests of the entrepreneurs.[5]

However, if one supports the thesis that the evolution of the economic system goes beyond the purely economic area, this need not inevitably lead to the dissolution of the entrepreneur function and its protective layers. The economic historian Hartmut Berghoff discovered that the 'new middle class(es) […] (will be) less middle class and not to the same extent as its classic predecessor(s) as milieu creating. They are unable to retain staff long-term and to produce social stability by means of long-term company goals' (Berghoff 2005, p. 15; our translation). Nonetheless, this has not resulted in a fallback in economic strength or innovation. Moreover, one could also present a counter thesis, namely, that the growing individualization of society in connection with a new allocation of social roles has brought about a different motivation towards self-employment. No longer can the 'will to found a private kingdom' – Schumpeter's forerunner of McClelland's Achievement Motivation Theory – be considered the motivational determinant of innovative behavior, but (in light of the lack of available jobs) the motivation born out of the necessity to ensure one's existence. This also serves to explain, for example, the development of the so-called 'Creative Economy': 'low rents and a widespread creative scene […] which [make] self-employment possible, the absence of jobs for life often making it even necessary' (Lembke 2006, p. 15; our translation). Of course, the level and modes of entrepreneurial activity are highly affected by the surrounding culture and by legal rules. However, there is no one-way direction in the development of society that leads inevitably to a destruction of the protecting strata.

Hypothesis 3: Growing intellectual hostility

Let us now consider the third thesis, a growing hostility towards capitalism that strikes at the very foundations of the moral authority of many institutions. In addition to the loss of the entrepreneur function and the erosion of the protective institutional layers, a general atmosphere that is critical of capitalism is developing in our sociopolitical environment, which is primarily promoted by intellectual forces. In other words, the legislative, administrative, and judicative practice is destroying the motivation and incentives of entrepreneurship, thereby permanently blocking the evolution function of dynamic entrepreneurialism.[6] Here one could surely make a connection to Mancur Olson Jr.'s theory, which identified the core cause of the rise and fall of nations as 'institutional sclerosis' and their related coalitions: 'The growth of coalitions, which are driven by the desire to secure a larger piece of the pie of national income, the rise in regulatory complexity and state activity, encouraging lobby activity as well as rising lack of transparency/clarity of the negotiations of these cartels, modify the incentives and the direction of evolution in society' (Olson 1982, p. 72).

[4] Schumpeter already referred to the company constitutional law problem areas, which Berle and Means addressed in the 1930s and much later highlighted within the context of New Institutional Economics under the name of Principal Agent Theory (cp. Berle/Means 1932; Erlei/Leschke/Sauerland 2007, pp. 103).

[5] Schumpeter's theory on the fall of the bourgeoisie can be nicely combined with a paper by the sociologist Christoph Deutschmann (2008), who states a 'collective Buddenbrooks Effect' for Germany. Within the framework of a multi-level analysis, he investigated how structural upward social mobility leads to a growing imbalance on the asset markets, which in the end has an effect on the overproportional growth of investment-seeking financial assets on the one hand, and a shrinking number of potential solvent debtors, on the other.

[6] For more on the difference between the innovation and evolution function, see Röpke 2002.

However, one could certainly disagree with this hypothesis, objecting to such a development. For instance, one could highlight the growing decentralization of the state apparatus and the institutional precautionary measures that act against one-sided political intervention. The United States Supreme Court Justice Louis Brandeis hence very appropriately described decentral federalized structures as "laboratories of democracy" (New State Ice Co. v. Liebmann, 285 U.S. 262, 311 [1932]). Furthermore, independent institutions have been established across the world to protect competition, which at least in theory aim to prevent rising monopolization of the economic system. Moreover, one could highlight that there can also be a change in thinking within economic and innovation policy, such as the discussion about so-called "supply-side economics" has shown (cp. Seidl 1984, pp. 139). Schumpeter's picture of the entrepreneur as an actor of social and economic change implies that entrepreneurs are particularly sensitive to the social embedding. Nevertheless, one might argue that entrepreneurs yet may partially resolve institutional deficiencies by innovative behavior or reliance on social networks.

3. The Recent Economic Crisis from Schumpeter's Perspective

Even though Schumpeter's more sociological thesis on the 'self destruction of capitalism' has at least not yet been fully proven, one could see the current economic crisis as empirical evidence (or as 'purely economic reason') for the fall of capitalism.[7] In terms of Schumpeter's Economic Theory, a move into a depression is dependent on "the mentality and temper of the business community and the public, the prevalence of get-rich-quick moral, the way […] in which credit is handeled in prosperity, the ability of the public to form an opinion about the merits of propositions, the degree to which it is given to belief phrases about prosperity plateaus and the wonders of monetary management and so on" (Schumpeter 1939, p. 150). Additionally, it is not possible to create 'theoretical expectations' about the beginning of depressions or their extent. According to Schumpeter, however, it is decisive to distinguish between two factors when dealing with the analysis of crises or depressions: first, the effects that are theoretically inherent in the capitalist system, in other words, 'normal' waves based on economic development dynamics; and, second, the social and political environmental factors, which are different in every crisis (Schumpeter 1934/1951, pp. 110).

Because of its effects, the current financial and economic crisis has often been compared with the Great Depression of 1929. Schumpeter explains this historical depression as follows: "coincidence of depression phases of all three cycles" (Schumpeter 1939, p. 907). Based on Schumpeter's Economic Theory and the "useful art grip" of the Three Cycle Scheme[8], the current global economic crisis could be interpreted as a collapse of the depression phases of two or possible three cycles. Eight years have passed since the last major crisis following the bursting of the New Economy Bubble in 2001, a period which corresponds exactly with a Juglar Cycle. Moreover, the 5th Kondratieff Cycle is now clearly in decline.[9] The automotive industry (4th Kondratieff Cycle) is to be seen as the 'grandfather' of Kondratieff Cycles, which can explain its current downfall – temporarily stalled with the aid of state funds (as basis technology; no growth, no new jobs). Irrespective of these developments, "there are no *purely economic* reasons why capitalism should not have another successful run which is all I wished to establish" (Schumpeter 1942/2008, p. 163, Fn. 7). As we have seen with the economic theory, fluctuations are theoretically normal in the development process; yet not necessarily crises such as the current type, which cannot simply be explained by market fundamentalism. Alongside the stagnation effects, which result from a diminishing Kondratieff effect, one must also consider those rejections that stem from politically motivated interventions within a complex economic system.

One can identify many surprising similarities between the depression of 1929 and today's situation, Schumpeter saw the fundamental difference between the Great Depression and earlier economic crises in that non-economic factors played a

[7] Schumpeter's image of the "March into Socialism" is to be seen as more of a hypothetical construct as he did not mark it with any time frame – but with institutional organization/construction possibilities.

[8] Schumpeter always emphasized that no hypothesis should be made with the Three Cycle Scheme. This scheme proved far more useful for the ordering of facts and is, hence, only to be seen as a "useful descriptive or illustrative device" (Schumpeter 1939, pp. 906).

[9] The exact time frame of the long Kondratieff cycles is difficult to determine. If one were to simply count forwards schematically, the fifth Kondratieff Cycle would now be at the beginning of a long-term decline. Schumpeter himself, however, assumed that the cycles would be reduced in the course of capitalistic development. Consequently, one often talks about the fifth Kondratieff Cycle as being in its end stages, while the sixth long wave of economic development is only in its early stage (cp. Nefiodow 1999; Siemon 2008).

dominant role: 'other things made a catastrophe out of that which would have otherwise been a mere depression […] political pressure on interest rates, organized resistance toward necessary adaptations, etc.' (Schumpeter 1934/1951, p. 114). With respect to social and political factors, the current situation the real estate bubble in the USA can essentially be seen to be responsible for the financial crisis. Two political interventions are largely responsible: monetary and interest rate policy of the American Federal Reserve Bank and poor institutional credit rating regulations for American mortgaging and banking (cp. Liebowitz 2008; Shiller 2008).[10] Schumpeter wrote that "[g]iven the way in which both firms and households had run into debt during the twenties, it is clear that the accumulated load – in many cases, though not in all, very sensitive to a fall in price level – was instrumental in precipitating depression" (Schumpeter 1939, p. 909).

Interestingly, economists like Kregl, Burlamarqui and Kattel have connected the Schumpeterian approach to Minsky's Theory of financial stability, thereby stressing Schumpeter's position that the role of money for an economic system is rather a problem of quality (e.g. financing innovations) than a problem of quantity (financing secondary wave's by-products: entrepreneurship of speculation, non-innovative and/or consumptive fields, areas of "reckless" and "fraudulent" enterprises). According to Minsky (1982, 2008), in a free market system, there are three different ways for business units to meet their financial commitments: hedge, speculative, and Ponzi finance. While a hedge position is characterized by "hedged" outstanding debts or financial commitments due to sufficient cash flows from operating activities (e.g. in case of promising business plans of innovators, combining given factors new in order to generate revenues to hedge their balance sheet and income statement), speculative positions do not cover all commitments. Thus, in the latter case the business unit needs to sell some of the assets, to cut the costs, or to borrow fresh money in order to meet financial commitments. In a Ponzi situation, the business unit is not able to to meet all commitments, which are larger than assets and debt potentials; in other words "financing costs are greater than income" (Minsky 2008, p. 231). Kregel has shown that this approach can be used for analyzing country positions in international economics (Kregel 1998, p. 5). In addition, Kregel and Burlamarqui (2006) have created a toolbox for the understanding of the way in which innovation (coupled with competition – both in industry and financial sector) can create something like Minsky's financing positions. For example, failed product development can lead to speculative or Ponzi positions (same results for the victims of creative destruction).

By trying to hedge the balance sheet or income statement, companies/entrepreneurs rely on a setting of capabilities (learning skills, expert knowlege and routines), motivation (in the sense of McClelland and Atkinsion) and property rights (cultural norms, laws etc.). These variables of action (see figure 1; framework by Röpke 1977 and 2002) develop and evolve in the wider context of the national system of innovation, which can further be characterized by "environmental turbulence" due to changes in the legal system, different structures of corporate governance, or special features of the education system. By being involved into a macroeconomic environment of exchange and inflation rates, social items – from an Schumpeterian standpoint – must be analyzed I order to show how entrepreneurs "move from short-term speculative positions to long-term hedged-positions (or not)" (Kattel 2009, p. 4). From this point of view, the Baltic States' path of development has been endangered from the beginning to be hit from a Schumpeterian crisis (in this case: a triple crisis of a Kichin, Juglar and Kondratieff downswing) due to the particular circumstanes: a strong free trade doctrine hindering the rise of dynamic comparative advantages in order to establish long-term competiveness within the process of catching up[11] and a lack of entrepreneurial history, hindering a process of entrepreneurial learning in order to deal with Schumpeterian downswings (learning from failure, learning to build and follow a high-value added path of vision).[12] The free market doctrine as a "stable environment created highly fertile grounds for short-term asset booms" (Kattel 2009, p. 10). The secondary wave's effects occured and "in the context of lowered risk-perception, abolished trade restriction, aggressive lending activity by foreign banks, and extensive use of easy credit drove

[10] In this context, an investment banker said to the *Frankfurter Allgemeine Zeitung*: 'Washington wanted more people to be able to afford a house and started to push interest rates. As a consequence, house prices rose, home buyers took more and more risks, making astronomical profits for the finance houses, which offered loans in complex non-transparent packages.' (Mejias 2008, p. 42; our translation).

[11] See therefore our second contribution in this volume referring to the case of Estonia.

[12] For an evolutionary perspective on entrepreneurial learning see Röpke (2002, Siemon 2006).

economic expansion by financing consumption as well as a real estate bubble. This resulted in skyrocketing asset prices that have enabled debt-led growth" (European Cooperation in Science and Technology 2011, p. 3). Hence, the easy credit boom of the early 2000s in the Baltic States "only covered up deeper structural problems created through industrial restructuring in 1990s" (Kattel 2010, p. 9).[13]

III Conclusion

This article showed Schumpeter's view on diagnosis and change in the capitalist system. First and foremost, innovation within an economy can be seen as fundamental for such change in an economic system, which has proven to be the "main trigger" in the development of capitalism caused by strong entrepreneurial efforts. Schumpeter regards change as development, seen as qualitative change of capitalist means of production. Such change is, however, not constant and continuous, but takes place in disruptive spurts, which vary in form and size. From this Schumpeterian standpoint, the Baltic crisis can be characterized as a problem of simultaneous downswings occurred by the fall of the 5th Kondratieff. Because the Baltic states are still within a process of catching up since the early 1990s, the ability to cope with this Schumpeterian depression became quite difficult due to a lack of entrepreneurial experience, specifically concerning how to act within a phase of depression. Foreign capital has been spent for non-innovative investments, thereby over-leveraging due to secondary waves effects. Furthermore, the established free market doctrine has hindered the channeling of foreign capital into innovative fields. Hence, the Baltic states are endangered of falling behind due to its liberal institutional reforms; they became highly vulnerable to "financial fragility" (in terms of Minsky).

How can a policy approach provide a process of Minskian hedging in order to stabilize a Schumpeterian process of economic development? Is Estonia (or the Baltic states in general) threatened to be stuck in this crisis due to a lack of "hedge positions," i.e. a "strategy of innovation" (Röpke 1977) or is there something like a natural path of an unstoppable upward for the Baltic states due to the liberal market environment?

Our conclusion is that it is necessary to integrate Schumpeter's pillars of economic development (innovation and finance) into the logic of comparative advantages (in the sense of Ricardo) in order to help the Baltic states rise like phoenix. Seen from a Schumpeterian perspective, the role of dynamic comparative advantage is responsible for the bulk of international trade fluxes, for the competiveness of innovative entrepreneurs in general, and for a state of financial stability. Hence, a strong upswing, triggering participation in the next Kondratieff wave (as well as Juglar and Kitchin waves), is necessary to enter a dynamic sphere of innovation.

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[13] In this context, Kattel refers to the so-called "flying geese" metaphor, of Akamatsu describing the catching up process by nations sequentially riding the same technological wave. A free market doctrine allowing a strong influx of FDIs, however, might be killing the geese, i.e. the rise of dynamic comparative advantages (Kattel 2010, p. 9).

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The concentration and competition in the banking sectors of the Baltic States in the context of a crisis

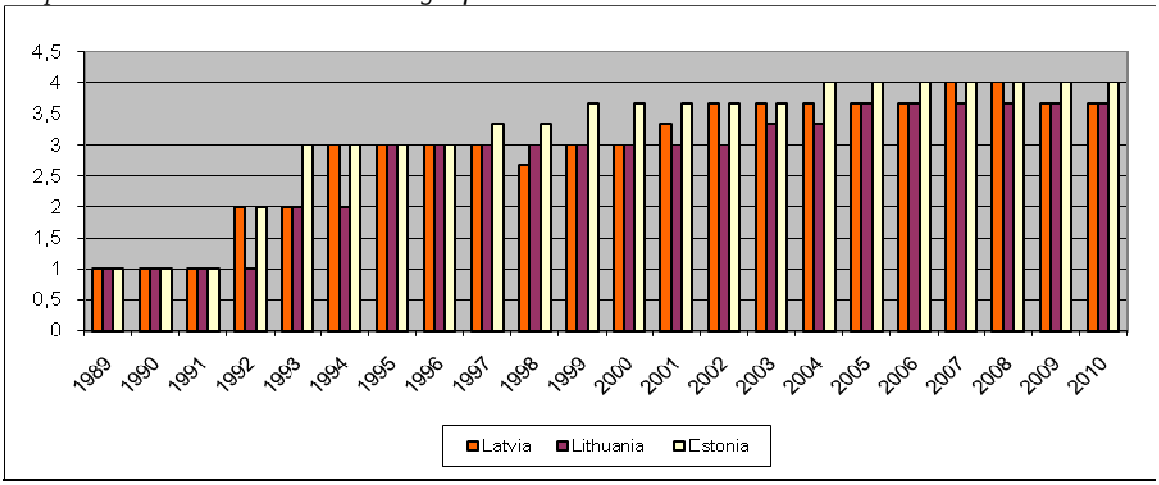
Introduction

The subject of the article is the banking sector of Estonia, Latvia, and Lithuania. The Baltic States (BS) followed similar paths of transformation. Despite many common features, however, each had a unique development, differing in the number of credit institutions, the share of foreign capital in the financial market, and macroeconomic conditions. The banking sector plays a significant role in shaping the economic conditions. In the context of global financial crisis, there comes a question about the impact and role of large concentrations of foreign capital in the banking sector. The aim of the article is to present the changes of the concentration levels and competition in the banking sector of Estonia, Lithuania, and Latvia. The article also shows that a highly concentrated banking sector is not more endangered by a crisis under certain conditions.

The changes of the banking sector structure in the context of EBRD transition indicators

The New Member States (NMS) went through three phases of transformation. The first phase was connected to the establishment of a centrally planned monobank system.[1] The second phase started in 1989, when a market economy was introduced after the communist system collapsed. The third phase of transformation was associated with the process of accession of these countries to the European Union. During the third phase, the Baltic states began very quickly to integrate with the international financial markets. Some authors suggest that the second and third phases are examples of a dual transformation, an adaptation both to a market economy and to the requirements of the EU. These changes resulted from political and international developments, including the growth of international trade, liberalization of capital flows, and improvement of the technological infrastructure. While assessing the transformation, the European Bank of Reconstruction and Development constructed *transition indicators*, which included *banking reform and interest rate liberalisation*. In the scale from 1 to 4+, the situation of NMS countries was similar only at the beginning. Thereafter, the level of transformation was graded higher in Estonia than Latvia and Lithuania (Graph 1). Since 2004, the EBRD estimated Estonia at the level of 4.0 due to the competitiveness and stability of the banking sector, efficient supervisory and flexibility of long-term financing for corporates, and the high share of foreign capital in banks. Latvia reached the level of 4.0 in 2007- 2008, but EBRD grades did not include public finance state of Latvia, where the banking sector lacked trust in the financial system. In 2009, the banking indicator for Latvia fell to 3.67 due to the nationalization of banking groups the year before. Lithuania was constantly graded at 3.67 in 2006-2010 thanks to the solid base of supervisory regulations, which defended this country from turbulences derived from a financial crisis.

Graph 1. Transition indicators. Banking reform and interest rate liberalization indexes in the Baltic States



Source: Structural Change Indicators, EBRD, www.ebrd.com, January 2011

[1] C. Stirbu, *Financial Market Integration in a Wider European Union*, HWWA Discussion Paper nr 297, Hamburg Institute of International Economics 2004, p. 11-12.

According to J. E. Stiglitz, the transition countries as a whole achieved the success less than statistics may suggest because of a very fast speed of privatization and price liberalization (called “shock therapy”) advised by international organizations, but having done so before the introduction of adequate legal regulations. In the end, however, the NMS came out positively through this transformation.

For and against the inflow of foreign capital into the banking sector of the Baltic States

The high share of foreign capital in the banking system in the Baltic countries has many effects on a wide range of issues. Undeniable advantages of the present capital structure include: de-politicization of the banking system, and therefore independence from government and the Treasury, improvement of the range and quality of banking services, implementation of new financial products and services, transfer of knowledge, technology and innovation (e.g. financial advisory, investment and electronic banking). ATM networks and the handling of credit cards require large amounts of money at the time of their initial implementation. Foreign banks have also been gradually introducing advanced professional services such as factoring, leasing, and derivatives. The benefits also include the implementation of accounting and reporting standards and higher standards for staff training. Extensive international relationships involved an increase of foreign currency payment transactions. At the beginning of the transformation, major banks with high market share functioned effectively due to a great margin gap between their mother countries and NMS. For a short period of time, all the necessary factors – capital, know-how, and technology – were available only as a result of foreign capital inflow.2 The entry of foreign banks has resulted in increased competition in the financial services market, which proved to be beneficial for customers.3 The inflow of foreign investments gives evidence to the economic and political stability of the country, and thus offers a chance to favorable pricing of country risk, lower margins, and commissions in dealing with foreign countries. The presence of global financial institutions in the country increases the entry of FDI, and vice versa; banks follow their customers.

On the other hand, the dominance of foreign capital in the banking system raises a long list of concerns. These include: loss of national identity of the domestic financial market, the possibility of discrimination against domestic companies when granting loans by foreign banks, acquiring strategic information about local businesses, the promotion of exports from mother countries, the use of transfer pricing and income shifting between markets (leading to the possibility of tax avoidance in the country of investment by foreign institutions), the transfer abroad of domestic savings, and focus on the wealthiest customers. This latter phenomenon associated with customer segmentation is described as "cherry picking." One characteristic is the development of personalized services to the wealthiest customers known as private banking. Banks with foreign capital were focused primarily on providing support to major domestic enterprises, especially foreign traders, foreigners living in the NMS, and the wealthiest citizens. Another argument is the failure of the transmission channel of monetary impulses from the central bank to the financial market through commercial banks with foreign capital.

Foreign ownership also has several downsides. These include the selection of areas in which foreign banks intend to operate, putting more restrictions on lending to SMEs, and lack of interest in financing low-income projects that are important from the standpoint of the economy. In addition, greater competition may motivate some of the weaker domestic banks to take excessive risks, which may lead to their bankruptcy. Less efficient banks can lose customers and go bankrupt. A threat to national banks' financial situation may cause destabilization of the entire banking sector. If foreign banks reduce their involvement in the country or depositors move their savings to a foreign bank, the crisis may deepen. The collapse or liquidation of the bank implies huge costs. However, limiting access to the banking sector for foreign capital would hamper the privatization. Global business of foreign banks may not necessarily coincide with the objectives of national banks. Nevertheless, in European transition countries it was not possible to finance the development of domestic investment by savings, so the share of foreign financial institutions seems inevitable. Foreign

[2] N. Borak, *Western Rules for Eastern Banking*, “Post-Communist Economies” 2000, Vol. 12, Nr 3, p. 293-295.
[3] C. Buch, *Opening up for Foreign Banks: How Central and Eastern Europe Can Benefit*, „Economics of Transition” 1997, nr 5, p. 339-366.

capital can also reduce the likelihood of speculative attacks on the currency of the country.4 This happens for two reasons: the involvement of global institutions, whose interests are represented in this country and strengthen the economy as a whole, including the introduction of a currency board system in conjunction with the euro (as the Baltic States did). On the other hand, banks with high foreign ownership of assets may show greater sensitivity to shocks caused by the home countries or other countries where these banks are present, and a currency board system is not an effective means to prevent currency exchange rate crisis. In addition to the opportunity to accelerate economic growth, financial sector development, and increase international competitiveness, we need to pay attention to the limitations of sovereignty management and greater vulnerability to external financial crises, including the phenomenon of generalization of the valuation of assets of the region and a domino effect. Recent history provides many examples in this perspective, so it is important to find a balance between the need of development and its implementation.

A clear assessment of the impact of foreign capital is very difficult.5 Proponents of foreign capital emphasize the qualitative development of the sector, the introduction of new financial products and services, and easiness to follow global technological trends. Critiques of foreign capital show a negative effect on the banking sector through such parameters as the number of bank branches, employment, or loans to businesses. The largest banks with domestic capital usually operate equally well as banks with a majority of foreign capital. An important result of the presence of foreign capital in the Baltics is the increase of banks' efficiency and less threat of insolvency due to a stronger capital base. It is estimated that in Europe more than 40 banking groups are operating in a cross-border way, via branches and subsidiaries in 17 EU Member States.6 For banks in the regions (directly or indirectly) bordering the Baltic countries the expansion was a natural extension of the domestic markets. These banks were SEB, Swedbank, DnB NORD Bank, Nordea group, and Danske Bank.

Table 1. The ownership structure of the banking system in the Baltic countries in the period 1997-2008

	Total number of banks				Total number of foreign banks				Share of foreign banks in banking sector assets **(%)**			
	1997	**2003**	**2006**	**2008**	**1997**	**2003**	**2006**	**2008**	**1997**	**2003**	**2006**	**2008**
Estonia	12	7	14	17	4	4	12	15	28,8	97,5	99,1	98,2
Lithuania	12	13	11	17	4	7	6	12	40,6	95,6	91,8	92,1
Latvia	32	23	24	27	16	10	12	16	70,6	53	62,9	65,7

Source: Banking Structures in the New EU Member States, European Central Bank, 2005, p. 17 and Structural Change Indicators, EBRD, www.ebrd.com, 31.12.2010.

Already a few years before EU enlargement, some Western banks took a key role in the Baltic States by purchasing the control packages in local banks (table 1). For large banking groups, those investments were part of the strategy at European or global levels. The selection of such a strategy by several banks in the region is a kind of necessity, due to their incomparable assets in a smaller ratio of the largest banks in the EU-15.

Competition and concentration in the banking sector

The way banks function significantly affects the nature of competition in this sector, as well as a bank's competitive position. Competition is a key element of market processes and mechanisms governing the functioning of the markets. Referring to the classic theory of perfect competition, it is based on the rivalry concept, building conflict or competition. The trend of cooperation underlines the importance of the relationship between market participants who do not serve to defeat the competition and increase customer loyalty. An American Nobel Prize winner, G. J. Stigler defines competition as rivalry between individuals, groups, or states.7 It should be emphasized that competition is a dynamic process. Actions taken to achieve better results and profits from the competitors include a number of methods and strategies to strengthen its market position as a result of price wars and collusion, aggressive advertising, and mergers and acquisitions.

[4] D. Gros, *Who Needs Foreign Banks*?, Centre for European Policy Studies, CEPS Working Document, Nr 185, September 2002, p. 1-10.
[5] S. D. Cohen, *Multinational Corporations and Foreign Direct Investment*, Oxford University Press, Oxford 2007, p. 179-200.
[6] J. M. González-Páramo, *Cross-border Banking in the EU: Development and Emerging Policy*, Speech by Member of the Executive Board of the ECB, Hong Kong 2006, http://www.ecb.int/.
[7] G. J. Stigler, *Perfect Competition, Historically Contemplated*, "Journal of Political Economy" 1957, Nr 65, p. 262.

An oligopolistic competition model characterized the structure of the banking sector in the 1970s and 1980s. After the development of the financial services market, a result of deregulation and liberalization of the financial sector, there was a shift in the direction of monopolistic competition. The banking industry generally is not homogeneous and consists of a group of large banks, which determine the price level in the market, and many small banks, which follow a prescribed level. Market structure of banking services may be based on the construction of monopolistic competition, perfect competition, and pure or differentiated oligopoly. Pure oligopoly is the functioning of a number of banks offering an almost identical product. Differentiated oligopoly is based on the market of several banks, when diversity characterizes products and services. Monopolistic competition occurs when there is a market for many banks, which are identified by customers due to the many opportunities. Given the declining number of banking entities in the sector due to mergers and acquisitions, it is worth bearing in mind that the small number of banks determines the behavior of market players and their efficiency and productivity.

Two approaches to the evaluation of competition appear in the literature: the classic model of SCP (structure - conduct - performance hypothesis) described by J. S. Bain8 and the ESH model (efficient structure hypothesis),9 based on the assumption that a positive relationship between profitability and market concentration is not conditioned by the degree of market power, but higher efficiency of operators is consistent with higher market share.

The structure of the banking sector is largely dependent on regulation, which defines its shape. Much of the regulation tilts toward oligopolistic competition, even with a moderate degree of concentration. A high degree of regulation of the banks is necessary because of their role as institutions of public trust and financial intermediaries, as well as the need to ensure stability and security of the financial system. Intense competition can eliminate weaker players, which in the case of the banking sector may destabilize the entire financial system. However, an excessive regulatory framework makes it difficult to achieve the efficiency and lowers the yield, which weakens the competitiveness of banks. Moreover, over-regulation implies a reduction in banks' responsibility for the results of their operations, and therefore weakens the impact of market self-discipline mechanisms. Protectionist measures are similar. They do not encourage flexible adaptation in a changing market environment. On the other hand, these are the same factors that affect the successful completion of mergers and acquisitions carried out in the banking sector. Similar to barriers to entry, there are also barriers to exit, even in the proper selection of the buyer entity and the sensitivity of banks as financial institutions to changes in securities prices.

In terms of the single financial market, there is a pressure to make inter-connections, resulting in the increase of concentration in the sector. Competition in the banking sector implies a decline in prices of banking products and services, while supporting innovation and forcing banks to take action which results in higher efficiency. Research of 10 European banks in the years 1996-2002 conducted by S. C. Valverde, D. B. Humphrey, and R. L. del Paso revealed that large banks have comparable abilities to establish competitive strategies due to a similarities in business environment, costs, and productivity when creating conditions for local leaders is supported by governments in order to make expanding market share possible. 10

High market concentration, however, may create conditions for oligopolistic competition, including the ability to impose higher prices and achieve higher revenues and profits. A study by H. Degryse, L. Laeven, and S. Ongena checked how organizational structure affects the competitiveness of banks.11 The study's authors concluded that the bank's geographic coverage, market share, and pricing strategy for loans is determined by the organizational structure of the bank and its competitors. Thebank's potential was lower when competitors had a larger market, a hierarchically organized structure, excellent communication technologies with customers and within the organization, a greater organizational focus, and strict relationships with the head office credit departments. Striving to increase the competitiveness of the bank, therefore, may include a desire to increase or maintain market share, gaining or

[8] J. S. Bain, *Relations of Profit Rate to Industry Concentration*, „Quaterly Journal of Economics" 1951, No. 65, p. 293-324.
[9] H. Demsetz, *Information and Efficiency: Another Viewpoint*, „Journal of Law and Economics" 1973, No. 10, p. 1-22.
[10] S. C. Valverde, D. B. Humphrey, R. L. del Paso, *Do Cross-Country Differences in Bank Efficiency Support a Policy of "National Champions"?*, "Journal of Banking and Finance" 2007, nr 31, p. 2137.
[11] H. Degryse, L. Laeven. S. Ongena, *The Impact of Organizational Structure and Lending Technology on Banking Competition*, "Review of Finance" 2009, nr 13, p. 225-259.

maintaining a leadership position, and the pursuit of profit. Identification of the factors of competitive advantage covers the market value of the bank, which affects the behavior of shareholders and other stakeholders in the environment of the bank. The source of a competitive advantage is also the bank's value added, which exceeds the value of the bank's capital. The study of competition and concentration are based on different methods, often giving similar results. If, however, a parameter deviates from the homogeneous results, it is often the source of the specificities of the country. The most commonly used measure of concentration and competition is based on the NEIO canon (New Empirical Industrial Organization). Literature falling within the scope of the canon promotes the use of Lerner's index, Herfindahl-Hirschman index, the CR rate and a study of parameters such as net interest margin, ROE (return on equity) and ROA (return on asset).12

Measures of concentration and dominance in the banking sectors of the Baltic States

Assessment of the degree of concentration and dominance in the banking sector in the Baltic States will be made using the ratio dominance Concentration Ratio for the number of banks adequate for the size of the banking sector and the Herfindahl-Hirschman Index (HHI), which is a measure of industry concentration. Undoubtedly, the economic dimension of concentration and deconcentration processes is becoming increasingly important in times of growth of transnational linkages and increased requirements in terms of competitiveness. HH indicator value is the sum of squares of the shares of all participants in a given market .

$$HH = \sum_{i=1}^{n} S^{2}_{i}$$

S^{i} - hare of funds, assets and liabilities respectively in the bank funds, assets, and liabilities of the entire banking sector, expressed in percentage points,

n - number of banks.

Because shares are raised to the square, the higher the HH index value, the more unequal the distribution of the market between the different entities. Moreover, when the other factors are constant, the rate will be lower when more entities are operating in the market.13 HH indicator value ranges from 0 for a perfectly competitive market to 10 000 for a pure monopoly. It is understood that if the ratio exceeds HH 1800, the market is characterized by high concentration. Table 2 and Figure 2 present HH index values for the analyzed countries. The highest degree of concentration, at the level of 3000-4000, is the Estonian banking sector and this case is closer to the model of oligopolistic competition. This, however, must be proved by the degree of dominance in the banking sector. The banking sector of Lithuania suggests a moderately high degree of concentration of less than 2000. The banking sector of Latvia during the analyzed period was characterized by a low degree of market concentration, characteristic for monopolistic competition. It should be noted that the HH index value in Estonia and Lithuania decreased gradually, which can be explained by the entry of new foreign companies into the banking sectors, especially in the way of greenfield investments and mergers and acquisitions.

Table 2. The value of Herfindahl-Hirschman index in the banking sector of Estonia, Lithuania and Latvia in 2003-2009

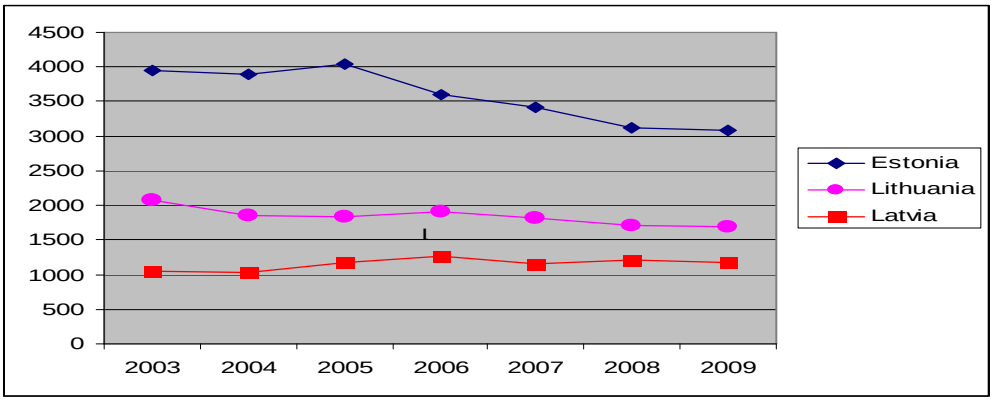
COUNTRY	**HERFINDAHL-HIRSCHMAN INDEX**						
	2003	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**
Estonia	3943	3887	4039	3593	3410	3120	3090
Lithuania	2071	1854	1838	1913	1827	1714	1693
Latvia	1054	1021	1176	1271	1158	1205	1181

Source: EU Banking Structures, European Central Bank, October 2008 and September 2010

[12] S. Carbo, D. Humphrey, J. Maudos, P. Molyneux, *Cross-country Comparisons of Competition and Pricing Power in European Banking*, "Journal of Money and Finance" 2009, nr 28, p. 116.

[13] HH index is the most popular tool for measuring market structure and it has the advantage over the rate of N-firms (Concentration Ratio N) due to the analysis of the participation of all participants on the market, not just the N-largest. Furthermore, it is a measure used to assess mergers in the U.S. and European antitrust law, which requires the consolidation of control in the event of a significant threat to competition.

Figure 2. The value comparison of Herfindahl-Hirschman index in the banking sector of the Baltic States in 2003-2009



Source: EU Banking Structures, European Central Bank, October 2008 and September 2010

Concentration Ratios N (CR N) also measure dominance in the banking sector. These indicate the share of funds, assets, and liabilities of the N country's largest banks, respectively, in relation to the total amount of funds, assets, and liabilities of the entire banking sector of the country.

$$CR\ N = \sum_{i=1}^{N} S^{i}$$

S^{i} - share of funds, assets, liabilities respectively N of the country's largest banks in relation to the total amount of funds, assets and liabilities of the entire banking sector of the country in the percentage points,

n - number of banks.

In this measure the most commonly used parameter values are the values of N = 3,4,5,10 and 15. The higher the concentration in the percentage points, the stronger the market is dominated by N entities. The amount of CR can be used to describe the market structure, so the value of CR1> 90% will mean the existence of a monopoly. The market is effectively competitive, meanwhile, when CR4 <40%, which means that the four largest market participants have market shares of at most 10% and other smaller players operate in the market. Monopolistic competition may be defined in a market where the value of the CR4 ratio ranges from 40 to 60%. Finally, a CR4> 60% indicates oligopolistic structure.

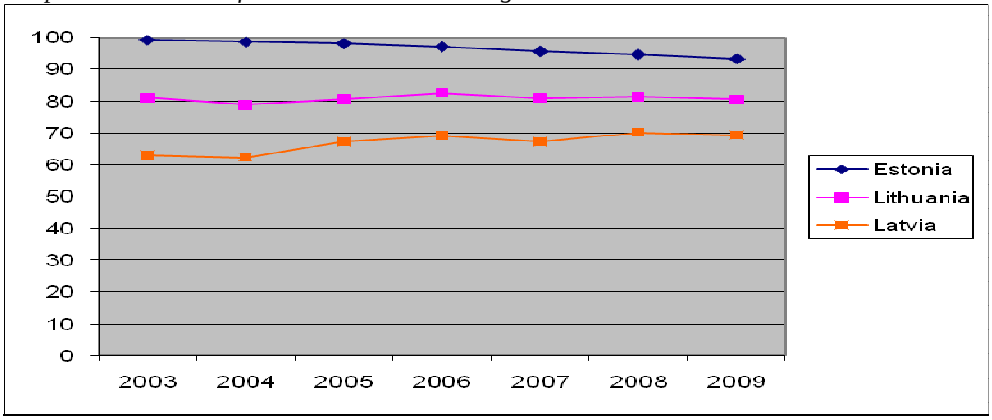
Below, CR will be assessed on the participation of the five largest banks' assets in the entire banking sector's assets of the country. Then, a process of assessing the type of competition on the basis of HH, CR4 (to explore the structure of competition in the banking market in the traditional model approach) and CR5 will be carried out. Table 3 and Graph 3 illustrate that CR5 concentration ratio in individual countries fluctuated slightly during the period. The highest degree of concentration CR5 was observed in the banking sector in Estonia, in which the lowest rate at 93,4% was recorded in 2009, and the highest levels, in the years of 2002 and 2003, were rated respectively 99,55% and 99,20%. Therefore, the assets of the five largest Estonian banks accounted for almost 100% of the assets of the entire banking sector.

Table 3. CR5 value of the assets in the banking sector in Baltic States in 1997-2009

Country	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Estonia	96,73	98,68	98,69	97,51	98,69	99,55	99,2	98,6	98,1	97,1	95,7	94,8	93,4
Lithuania	91,37	93,84	87,41	86,53	87,6	83,94	81,0	78,9	80,6	82,5	80,9	81,3	80,5
Latvia	49,98	55,74	55,98	55,9	63,41	65,34	63,1	62,4	67,3	69,2	67,2	70,2	69,3

Source: EU Banking Structures, European Central Bank, October 2008 and September 2010

Graph 3. CR5 value of the assets in the banking sector in the Baltic States in 2003-2009



Source: EU Banking Structures, European Central Bank, October 2008 and September 2010

A high degree of domination can be also observed in the banking sector of Lithuania, where CR5 changed periodically. At the end of 2009, 80% of the Lithuanian banking system's entire assets were under control of banks with Scandinavian capital, while two of the biggest investors in the Lithuanian banking system, SEB and Swedbank, had 29% and 22%, respectively. Moreover, SEB and Swedbank held the biggest share in leasing, life insurance and pension funds markets. The development strategy of the Swedish parent bank groups will have real influence on the further development of Estonia's and Lithuania's banks and its financial system. The country with the lowest degree of dominance was Latvia, but in this country the banking sector was increasingly dominated by major banking institutions (CR5 ratio increased between 1997-2009 from less than 50% to 69,3%). The average value of the CR5 in the banking sectors of the Baltic States in the period of 1997-2009 increased by 2%, which leads to the conclusion that the consolidation processes and foreign capital inflow in the region of the Baltics did not materially affect the degree of dominance of the largest banks in the banking sectors of the analyzed countries. It is worth noting that these results differ from results obtained for the other NMS that accessed the EU in 2004 and 2007. The average value of CR5 in the banking sectors of these countries during the period 1997-2007 decreased by 14%. Even in 2000, the NMS had two characteristics: too few assets and deposits (the region was determined in this respect as the underbanked) and an excessive number of banks (overbanked). In both cases, consolidation and FDI seemed to be approaching a solution to banking sector stability.

Table 4. Summary of concentration ratios in the Baltic States in 2009

COUNTRY	HERFINDAHL-HIRSCHMAN INDEX *	CONCENTRATION RATIO 4 (%)	CONCENTRATION RATIO 5 (%)	COMPETITION
Estonia	**Very high**	95,4	93,4	Monopoly/Differentiated oligopoly
Lithuania	**High**	75,4	80,5	Differentiated oligopoly
Latvia	**Low**	62,1	69,3	Monopolistic competition

* HH 0-1000 very low, 1000-1800 low, above1800 high, above 3000 very high
Source: Author's calculations.

On the basis of the HH and CR4 indicators, we can determine what kind of competition characterizes the banking sector in the countries studied. Table 4 summarizes the levels of HHI, CR5, and CR4, obtained through calculations based on the statistics published by central banks. One can conclude that the competition in Estonia is close to a monopoly, associated with the dominance of the largest bank, which is Swedbank Tallinn, with a share of 78,5% in Estonian banking sector assets. The Lithuanian sector is also highly concentrated, but the largest bank in Lithuania, which is also Swedbank, has "only" 29% share of the assets of the banking sector. High concentration in these countries is confirmed by Herfindahl-Hirschman index. Latvia has a 62,1% level of CR4; the index of HH at a level of 1181 documents a low degree of concentration, which is confirmed by the value of CR5 (69,3%).

Is high concentration unsafe?

The research on concentration and domination in a banking sector is important in the context of the crisis when the banking sector remained the most essential guarantee for the stability of the financial system. For example, despite the fact that assets of the Lithuanian banking system declined by 6,1% in 2009, the asset share of the banks increased and accounted for slightly more than 80% of the total financial system assets.14 The three largest Scandinavian banks (SEB, Swedbank and DnB NORD) not only controlled the largest share of the Baltic States' banking system assets, but they also played an important role in the country's non-banking sector – leasing and life assurance markets. Therefore, the financial situation of these banks is of the most importance to the development and stability of the Baltic States' banking system. At the end of 2009, Scandinavian bank groups together controlled around 75% of the total Baltic countries banking system's assets. In Latvia, their share was slightly lower due to a significant market share of the local banks, while in Estonia, nearly all of the banking system was under the control of these bank groups. Swedbank and SEB groups are the biggest investors into the banking system in the Baltic States; they control around 50% of the Baltic countries banking system‘s assets. Subsidiaries of these Swedish bank groups follow intensive activities in all three Baltic countries, a home market for the groups. Other important investors into the Baltic countries' banking system are Nordea and Danske Bank groups, which have affiliates in all three Baltic countries, and a Norwegian DnB NOR Bank group.

Studies on competition and concentration are usually based on the assumption that bank competition is positive from a social point of view. Generally, higher concentration is accompanied by less favorable pricing terms offered to customers of banks, higher profitability and profits, as well as poorer access to credit, which in theory should determine the lower competition. However, these relationships may not always be so strict and unchanging. In countries with more liberal regulations and a higher concentration of foreign ownership, the impact is much weaker on the occurrence of these phenomena. An example would be Finland's banking sector, which was highly concentrated. The three largest banks (OP Bank Group, Nordea, and Sampo) in 2003-2006 had a 70% market share in loans and deposits. However, as demonstrated by research conducted by J. Molnar, retail credit sector could be regarded as competitive and margins were rather low for the bank.15 Banks receive the income largely from activities other than loans, for example asset management. This situation is similar to the functioning of the Estonian banking sector.

On the other hand, O. de Jonghe and R. V. Vennet demonstrated in their research on potential agents of European banks' operations that banks having an efficient management system and advanced technologies in the long term gain competitive advantage.16 In addition, it turned out that the concentration of the banking sector does not affect equally the operators acting on it. Only banks that have a large share in a concentrated market generate non-price benefits. Macroeconomic conditions and specific individual markets have an important impact on the functioning of banks: while the variables specific to the banks explained 11.7% of banks volatility, the variables specific to the country explained more than 30% of the variation. The above arguments confirm the supposition that quantitative tests are not sufficient to fully assess the situation in the sector.

Margins and the structure of banking in the Baltic States in the context of a crisis

The banking sectors of NMS were attractive for foreign investors who expected to achieve income from operations in emerging markets. Net interest margin (NIM) is the difference between coupon income and expenditure related to interest (i.e. interest paid to depositors). NIM is one of the major indicators of cost in banks and can show the current degree of competitive condition in a market, but can also reflect other factors, such as market power and risk appetite. NIM covers the costs of banking services. When it exceeds the costs of the bank, it may be a source of profit. The existence of profits is an incentive for the entry of new banks, which increases competition in the market and produces a downward pressure on interest margins. Therefore, with a larger number of competing banks interest falls mainly on

[14] *Financial Stability Review 2010*, Lietuvos Banka, Vilnius, January 2011, p. 11.
[15] J. Molnar, *Market Power and Merger Simulation in Retail Banking*, Discussion Papers 2008, nr 4, Bank of Finland, Helsinki 2008, p. 13-18.
[16] O. De Jonghe, R. V. Vennet, *Competition versus Efficiency: What drives Franchise Values in European Banking ?*, "Journal of Banking and Finance" 2008, nr 32, p. 1820-1821.

loans, and the intensifying competition contributes to offering the customers higher interest on deposits. Both these effects lead to a reduction in interest margins.

In Estonia, Latvia, and Lithuania, net interest margin reflected a significantly higher level than the average in the European Union. In 2008, the margins were at the respective levels of 2.55%, 2.82% and 2.38%, while the EU average was 1.87%.17 Faced with insolvency risk and other balance sheet problems, many EU governments decided to offer financial support to credit institutions, including partial or full state involvement in the restructuring process. The government stakes in banks have raised some concerns on cross-border competition and the existence of a true level playing field in the Internal Market. However, basic indicators of competition, such as NIM, did not show significant changes during the crisis in the EU.

The study of determinants of interest margins in NMS was carried out by M. S. Schwaiger and D. Lebieg.18 They found that in the banking sectors of transition countries higher net interest margins were achieved than in countries with a "mature economy." The major causes included credit risk, and, to a lesser extent, interest rate risk. NIM is significantly affected by higher efficiency, lower operating costs, a higher proportion of non-interest income, lower risk aversion, a higher level of competition, and lower implicit interest payments. The presence of foreign capital through direct investment, in the light of these studies, brings a positive impact on margins, due to possible refinancing of the banks and possibility of moving the capital and its guarantee within the banking group.

These theoretical assumptions were confirmed by K. Drakos in his studies on the effectiveness of the banking sectors of transition countries. He stated that the margins decreased significantly, largely due to the expansion of foreign entities, which in turn implies the success of the reform of the banking sectors. At the same time, he pointed out that the margins were different in public and private entities, which also indicated dependence of bank margins on the ownership of banks.19

The study by C. Valverde and F. R. Fernandez concerning NIM values in conjunction with market power and specialization of the bank determined that the bank's market power increases when revenues are derived from a diversified portfolio of banking products and services.20 Net interest margins resulting from non-interest income. in 2004-2006 were the highest in the euro area and slightly lower in the EU-15. Since 2004, however, average non-interest margins in Latvia and Estonia were higher than those in the EU. The level of non-interest margins affects the practice of tying banking services, such as mortgage lending, with current accounts and signing of contracts for life insurance, as well as linking them to the current account of consumer loans, or loans to small and medium enterprises. Most of such relationship occurred in the banking sector in Latvia21.

In 2000-2006, most countries in transition experienced a significant increase in lending to the private sector, especially in Estonia and Latvia. The problem of excessive lending by the banks of the NMS has been widely studied. By 2005, however, a greater weight of lending in national currency than foreign was observed. This was partly explained by the decline in interest rates, rising incomes, generating economic growth, and increase in property prices. It changed afterwards to the foreign currency lending. As stated by G. Kiss, M. Nagy, and B. Vonnák, a contributing factor to the tendency of lending revenue decline was a reduction in banks' interest margins. Banks tried to compensate this fact by increased lending.22 In the Baltic States, an increasing trend for private sector loans and a downward one for loans to firms was observed.

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[17] *European Financial Integration Report 2009*, Commission Staff Working Document, European Commission, Brussels, 11.12.2009, p. 21-22.
[18] M. S. Schwaiger, D. Liebeg, *Determinants of Bank Interest Margins in Central and Eastern Europe*, Financial Stability Report 14, Oesterreichische Nationalbank, Vienna 2008, p. 68-82.
[19] K. Drakos, *Assessing the Success of Reform in Transition Banking 10 Years Later: an Interest Margins Analysis*, "Journal of Policy Modeling" 2003, Volume 25, Nr 3, p. 309-316.
[20] C. Valverde, F. R. Fernandez, *The Determinants of Bank Margins in European Banking*, „Journal of Banking and Finance" 2007, nr 31, p. 2043-2063.
[21] *European Financial Integration Report 2009*, op. cit., p. 21.
[22] G. Kiss, M. Nagy, B. Vonnák, *Credit Growth in Central and Eastern Europe: Convergence or Boom?*, Magyar Nemzeti Bank, MNB Working Papers 2006, No. 10, p. 10.

A worsening of financial standing of the borrowers and declining collateral value, together with a very conservative approach to the credit risk for enterprises, were the main reasons behind credit losses in the Baltic countries in the time of financial crisis since 2007.23 Scandinavian parent banks reported the biggest losses. In 2009, Swedbank and SEB groups accounted their euro loan portfolio impairment losses for respectively 2.4 bln EUR and 1.2 bln EUR, of which 61% and 78% derived from the Baltic countries. Lower cost of financing accompanied by higher interest rate margins led to an increase in the NIM, while floating securities turnover and rising stock prices contributed to the growth of intermediation and investment management charges. All these factors made possible to achieve operational profit used to cover the part of losses in the banks of analyzed countries (table 5). Nordea and Danske Bank parent bank groups reported that only a small portion of their income came from the operations in the Baltic countries, therefore economic situation in Lithuania and other Baltic countries has insignificant effect on the operational results of these bank groups.

Table 5. Profitability of Scandinavian bank groups measured by ROE (return on equity) in 2006-2009

Bank group	2006	2007	2008	2009
SEB group	20,8	19,3	13,1	1,2
Swedbank group	19,3	18,9	15,2	–12,5
DnB NOR Bank	19,5	22	12,4	10,6
Nordea group	22,9	19,7	15,3	11,3
Danske Bank group	17,5	15,1	1,0	1,7

Source: Financial Stability Review 2010, Lietuvos Banka, January 2011

Concluding the net interest margin concern, the banking sector of the Baltic States have already developed enough to be able to function efficiently, even at the time of the global crisis. Efficiency of banks at the microeconomic level is generally associated with improved management and obtaining economies of scale and scope. Leading banks invest the most in the development of information technology and quality to achieve higher efficiency. Efficiency on a macroeconomic level requires better risk diversification, lower transaction costs and skillful allocation of resources into financial revenue generating projects.24 A well-functioning banking sector can work even at lower interest margins and interest rates, higher deposits, developing and stimulating business investment, and household consumption.

The effects of a financial crisis on concentrated banking sectors in the Baltic States

Many authors (Group of Ten, A. N. Berger and R. S. Demsetz)25 reported in their study that the effectiveness of the bank increases only to a certain amount of assets, over which big players may feel diseconomies of scale. This correlation may exist due to the complexity associated with managing the larger banks. It should be noted that the natural economic factor, limiting the growth of the banks, thus impeding cross-border integration and building large-scale pan-European banks, is the tendency to move liquidity crises.

F. Fecht and H. P. Grüner demonstrated in their study that a compromise may be found between the benefits of diversification and the costs of crisis contagion phenomena, if the banks merge from two different regions with different risk and it is the preferred option from the viewpoint of the bank's operational risk.26 In the model built by Fecht and Grüner, liquidity deficit in one region may then be discounted by surplus liquidity in another region. If the bank expands into the third region, liquidity risk increases, when the volume of liquidity deficit is escalating. The greater the number of regions, the greater may be the risk of liquidity shock. The authors put forward the thesis that the size of the bank engaged in mergers and acquisitions is less important for the safety of its balance sheet than the number of countries in which it makes an expansion of the consolidation. The conclusion is that the advancement of integration in the European banking sector characterized by cross-border mergers would be higher if the EU took place a greater differentiation of risk of banking in various countries. The described model explains the high degree of interest in

[23] *Financial Stability Review 2010*, Lietuvos Banka, January 2011, p. 9.
[24] M. Eller, P. Hass, K. Steiner, *Foreign Direct Investment in the Financial Sector and Economic Growth in Central and Eastern Europe: The Crucial Role of the Efficiency Channel*,, "Emerging Market Review" 2006, nr 7, p. 301.
[25] *Report on Consolidation in the Financial Sector*, Summary Report, Group of Ten, Bank for International Settlements, January 2001, chapter VI; A. N. Berger, R. S. Demsetz, P. E. Strahan, *The Consolidation of the Financial Services Industry: Causes, Consequences and Implications for the Future*, "Journal of Banking and Finance", February 1999, Vol. 23, p. 135-194.
[26] F. Fecht, H. P. Grüner, *Limits to International Banking Consolidation*, "Open Economies Review" 2008, Volume 19, Nr 5, p. 651.

acquisitions of banks in the region of the Baltic States by Scandinavian banks. It is still unclear, however, what the optimum size of the consolidated banking group is.

It is worth emphasizing that despite the high share of foreign capital in the region, no bank has fallen. However, credit expansion in earlier years has generated substantial debt charged to the financial performance of banks. The most serious case was of Parex bank, which was subjected to the method for the bank takeover and restructuring, called P&A (purchase and assumption).27 This technique is widely applied by the Federal Deposit Insurance Corporation in USA and will be useful for the resolution related to a further management of Parex Banka, taken over by the state of Latvia.28 In 2008, Latvian Parex bank encountered liquidity problems due to imbalances of short-term liabilities and long-term loans (only those related to real estate projects accounted for 44 %). Compared to 2007, deposits in Parex bank declined by 36% during the crisis. The highest quality assets and liabilities of the bank will be likely separated and sold to a private investor.

To sum up the considerations taken in the work, the Baltic banking systems have successfully adapted to the changing macroeconomic environment. Despite record high losses, banks also have accumulated a significant amount of liquid assets and maintain positive levels of capital adequacy ratios.29 However, many banks recorded significant impairment of their loan portfolios in 2007-2009. A high concentration level and immense share of foreign capital were not the main destabilizing factors for the region. Improving macroeconomic situation should help to the banking system. The share of loans that recorded obliteration should decline leading to a general enhancement in the loan portfolio quality. The recovery of the domestic economy will lead to an improvement both in crediting and bank revenues. Further impairment could be possible only in case the difficult economic development scenario materializes in the world.

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[27] The main P&A advantage is that this method allows customers to further use bank services uninterruptedly. With proper advance preparations, it is possible to restructure a problematic bank, to decompose the bank assets into two parts, and transfer insured deposits into another bank, in a very short period of time – usually one weekend. A purchase and assumption of a problem bank weakens a possibility of the break out of depositors' panic (run on banks) and failure of the financial sector operation. Compared to announcing the bank bankruptcy, this method allows the reduction of expenses of the deposit insurance institution by transferring a part of the bank assets and liabilities to a private entity. This is also beneficial for the bank taking over, provided with an opportunity to develop the business of a bankrupt bank in a certain geographical region and customer segment.

[28] By the end of 2009, the government had deposited with the bank an amount equal to 622 mln LVL, as a liquidity support, while the capital injection by the government exceeded 195 mln LVL.

[29] *Financial Stability Review 2010*, Lietuvos Banka, January 2011, p. 58.

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Constraints of economic development of East European economies in the context of the unpredictability of Russian economic policy measures

Introduction

International trade plays a significant part in the world economy. Trade, in fact, drives general economic growth. Although the relevance of the domestic demand – consumption and investment – to economic growth should not be underestimated, exports generally drive growth without leading to a deficit in the balance of payments and support both economic activity and growth. It is therefore understandable that foreign economic policy has recently gained in significance. One of the most challenging consequences of the global economic crisis, moreover, is the increasing level of trade protectionism.

Estonia, Latvia and Lithuania gained independence from the Soviet Union in 1991. In 2004, Poland and the three Baltic States, former COMECON countries, joined the European Union. Independence from the Soviet Union created new trading relations and changed their focus towards the west. However, the Russian Federation continues to be an important trade partner for all parties involved.

It is necessary for Poland and the Baltic States to accelerate their economic growth in light of the global economic crisis, when countries all over the world are subject to the pressure of protecting their economies, which usually accompanies an economic slowdown. In this context, the role of trade with neighbouring countries, especially those with big and unsaturated domestic markets, gains in importance.

The Russian market thus seems to be a particularly attractive choice from the viewpoint of both Poland and the tree Baltic States. Russia is one of the most promising export destinations with an extremely large number of consumers. Trade with Russia is profitable for all four countries for a number of reasons:

- geographical proximity, which reduces transport and distribution costs;
- similar cultures and related awareness of consumer preferences and habits, which facilitates trade negotiations;
- a long tradition of trade cooperation; both countries used to be the major trade partners for each other for many years;
- the attractiveness of the Russian market to all the EU member states, which is an additional advantage for Poland and the Baltic States.

Russia, being their large eastern neighbour, still exerts significant influence in a range of areas. It is therefore crucial for the three Baltic States and Poland that significant levels of Russian trade protection is eliminated, especially considering that all four are interested in deepening trade and investment relationship in its immediate vicinity. In this context, moreover, Russian membership in the WTO may play a special role as a catalyst for its unilateral trade policy decisions and actions. It may be regarded as an appropriate framework for exercising Russian influence in the trade area, as it will lay the foundations for comprehensive reforms in trade regimes.

On the other hand, the Russian market is highly competitive and facing it is a difficult task. As a result, entering this market and becoming established there is a real challenge to foreign enterprises, the more so because the preferences and expectations of Russian consumers are increasingly demanding. At the same time, the Russian market is not regulated by precise norms within the trade or competition policy, and a number of international trade norms and standards are not respected. This is a result of the fact that Russia is not a member of the World Trade Organisation. As a consequence, there is no institution which would supervise the rules of access to the Russian market, assert one's own rights or settle litigation. It implies that Russia may take independent decisions related to the trade policy without consideration for the trade partners involved.

Russia is the EU's third biggest trading partner, with Russian supplies of oil and gas making up a large percentage of Russia's exports to Europe. Trade between the two economies had shown steep growth rates until mid 2008, accounting for 52.3% of its overall trade turnover in 2008. This trend was interrupted by the economic crisis and the unilateral

measures adopted by Russia, which have affected this bilateral trade. In 2009, EU exports of goods to Russia achieved EUR 65.6 billion and imports of goods from Russia were EUR 115 billion**.** Imports from Russia are mainly energy and mineral fuels products (77.3%), some manufactured goods chemicals and raw materials. EU exports to Russia are diversified, covering nearly all categories of machinery and transport equipment (42.9%), manufactured goods, food, and live animals[1].

The EU is by far Russia's main trading partner. It is also Russia's most important investor. Up to 75% of FDI stocks in Russia come from the EU member states[2]. At the centre of EU-Russia relations at present are ongoing WTO accession negotiations. In this context, Poland and the Baltic states, because of their geography and cultural ties, could have served as a bridge to Russia, which is an important partner for all members of the EU. However, there are many disputed points that require negotiation on both the national and European levels. Estonia, for instance, is becoming more dependent on Russia for natural gas imports. Of the three Baltic states, Lithuania has the highest share of trade with Russia today, but it is trying to reduce dependence on Russian energy. In January 2011, the Lithuanian Energy Ministry lodged a complaint with the European Commission regarding Gazprom's alleged abuse of its dominant position. The ministry requested the Russian gas concern to apply a transparent, fair, and non-discriminatory policy on natural gas. In another case, in 2009, Russia attempted to raise export tariffs for raw wood from EUR 15 per cubic metre to EUR 50 per cubic metre. This posed a threat of bankruptcy to many Finnish enterprises dealing with wood processing. It was not until Finland intervened in the European Union, however, that Russia's prime minister, V. Putin, introduced a moratorium on this decision.

It seems, therefore, that considering the structure of trade with Russia, the barriers for some industries are extremely restrictive. Thus will undoubtedly remain so, as the research shows, since there is a strong lobby in Russia who wants to limit the access to the market for competition. This fact emphasises even more the need for Russia's membership in the WTO.

The role of the WTO in the global trade

The World Trade Organisation is one of the most important pillars of the global economic order. It is an integrated system of rules applying to individual spheres of trade (goods and services, foreign investment, intellectual property rights), including dispute settlement procedures. The philosophy of the WTO is based on the view that open markets, lack of discrimination, and global competition support the welfare of individual countries. As a result, the WTO makes a variety of efforts to increase the transparency of trade policies adopted by its members. It is important that those national standards are not allowed to deviate from the common rules. It follows that in order to reduce the scale of protectionism, it is essential that all countries in the world become members of the WTO, especially those which exert a particularly high impact on the situation in global markets.

Nonetheless, the "great absent ones" among the WTO members still include Russia. It is the biggest economy and the only G-20 country which does not belong to the WTO even though it submitted its application for membership in 1993. Although major reforms have already been made in the Russian economy, the major dispute areas which require further accession negotiations include the level of allowed agricultural subsidies, the Russian export tariffs for wood, and the rules regulating the operation of state-owned enterprises in Russia.

In general, however, foreign companies still face a number of tariff and non-tariff trade barriers when exporting to Russia. One of the major complaints is Russia's complex system of standardization. It stems from the lack of clarity and transparency, and overall redundancy. Foreign providers of non-financial services experience discrimination not as the result of federal Russian law, but the result from violation practices from local authorities (fees to be paid to obtain licenses, while domestic firms allegedly omit it by bribes).

[1] *European Commission, Trade: Russia*, http://ec.europa.eu/trade/creating-opportunities/bilateral-relations/countries/russia/ (26.01.2011).
[2] Ibidem.

Key decisions the Russian Federation had to make included binding tariffs, defined levels of subsidies in agriculture, and commitments on services. By now, Russia has successfully negotiated all relevant bilateral accession agreements with all members except Cambodia, Vietnam (both new members) and Georgia. Conflict with Georgia is still delaying the accession process. As a matter of fact, Russia has already agreed to reduce its bound MFN tariffs to about 8 per cent on average. Liberalization covered important services sectors, but in some sectors commitments have not been agreed. Among others in the insurance sector, foreign insurance companies are subject to a 49% equity restriction. Foreign full participation in the insurance sector will be allowed only five years after the date of accession. Only the EU insurance companies enjoy more generous treatment as they can offer life and mandatory forms of insurance in Russia directly, without the requirement to work through a majority Russian-owned partner3. The other issue is that Russian federal law permits foreign banks to establish subsidiaries in Russia but does not allow them to establish branches. After accession to the WTO, Russia will allow foreign ownership to account for 70% of the country's total banking sector equity with some restrictions concerning bank employees4.

Tight government regulations also restrict other important sectors for FDI such as the telecommunications and aerospace industries. Purchase of agricultural land and land close to federal borders (or in areas determined as critical to national security) by foreigners is still prohibited. In May 2008, a list of 42 restricted sectors was introduced in which purchases of "controlling interests" by foreign investors must be pre-approved by the Russian government. The list of strategic sectors includes not only sectors involved in military production but also production and sales of natural resources and their extraction, newspapers with a circulation of more than one million, etc. It leads to non-transparent and burdensome process of approval. It is expected that Russian commitment to reduce aircraft tariffs as part of its WTO accession will help them purchase the modern, fuel-efficient aircraft they need to remain competitive with foreign airlines.

Considering that Russia and over 40 other countries do not belong to the WTO, the Organisation's regulations do not have a universal character. The WTO's legal regime aims to guarantee access to export markets. Those regulations ban raising tariffs over the accepted level, discriminating exporters from different countries, offering them different terms and conditions of access to the domestic market, and applying unjustifiable sanitary or phytosanitary requirements or standards concerning product safety. The regulations also detail the principles of applying market protection measures aimed to ensure that each WTO member freely exports its products to the markets of other members according to the equal treatment principle. It implies that as soon as Russia joins the WTO, the introduction of numerous barriers to imports from other member states will be much more difficult. Although the Russian authorities may deliberately breach those regulations, they will be threatened with litigation before the WTO Dispute Settlement Body (DBS). And even though such trials are long and it is sometimes difficult to enforce lifting inconsistent regulations, the members have an opportunity to seek justice and impose sanctions on the countries that breach common regulations. If a country remains beyond the WTO structures, however, there is no institution that could award damages, which often leads to deliberate wrongdoing that cannot be punished.

Russia's accession to the World Trade Organisation will generate for this country medium-term and long-term benefits estimated on an annual basis at USD 53 billion and USD 177 billion, respectively, mostly owing to the liabilities in the trade in services.

The characteristics of protection measures applied against Pomeranian enterprises in the Russian market

Russia's obedience to the WTO regulations is crucial to Poland's exporters. According to the results of a questionnaire survey of Pomeranian enterprises, exporters are aware that the WTO may have a significant impact on their competitiveness in foreign markets. It may also play an important part as a mechanism securing their trade interests in this market.

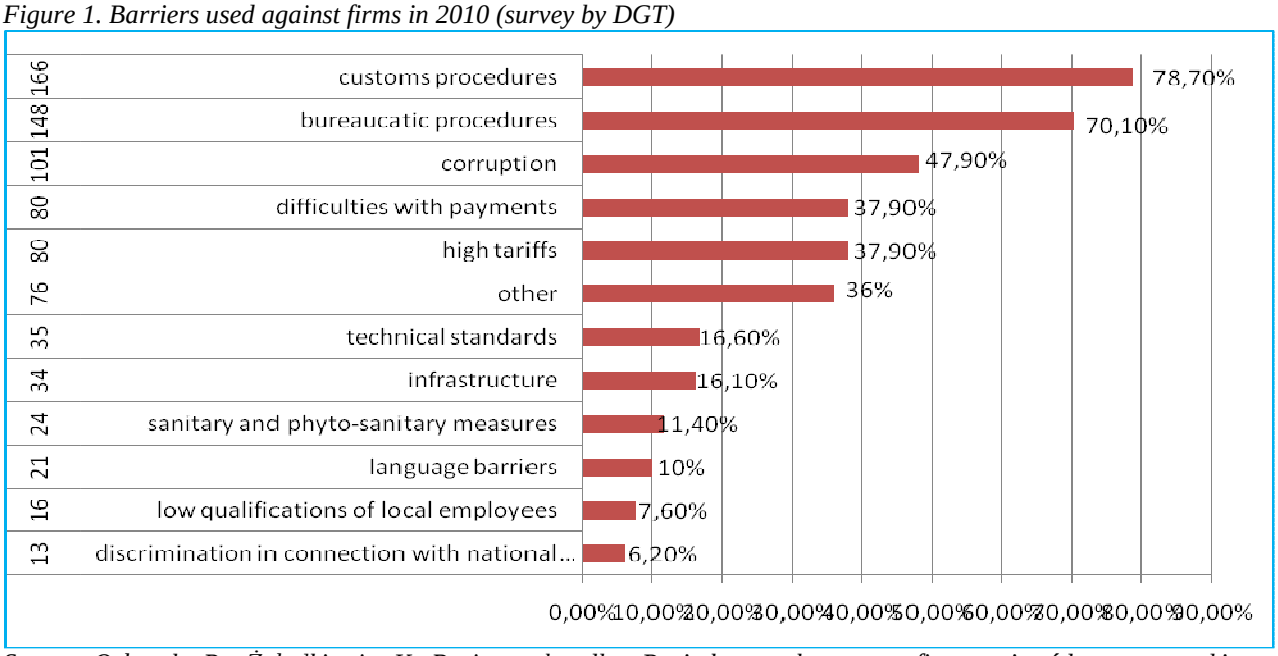
[3] However, until Russia's accession, EU firms are to act in accordance to Russian law, which requires that chief executives and chief accountants of foreign insurers operating in Russia be Russian citizens.

4 At least 75% of the bank's employees and 50% of the bank's management board must be of Russian nationality if the chairman is not a Russian citizen. Heads of foreign banks' Russian offices are required to be proficient in the Russian language.

The characteristics of the trade barriers existing in the Russian market are based on a questionnaire survey among 308 enterprises from the Pomeranian Voivodship. 211 (i.e. 68.5%) respondents confirm their cooperation with Russia. Further analysis is based on this group of exporters.

The highest share (78.7%) of the analysed enterprises claims that customs procedures cause most of the problems in their export to the Russian market. Bureaucracy is the next most common source of problems (70.1%), and nearly half of the exporters (47.9%) point to corruption as a significant obstacle. High trade tariffs, technical standards, and phytosanitary barriers are also mentioned as sources of problems (see: Fig. 1).

Figure 1. Barriers used against firms in 2010 (survey by DGT)



Source: Orłowska,R., Żołądkiewicz,K., Bariery w handlu z Rosja bnapotykane przez firmy województwa pomorskiego, in: Eksport oraz bezpośrednie inwestycje zagraniczne firm województwa pomorskiego, ed. S. Umiński, PBS DGA, Gdańsk 2010, p.103.

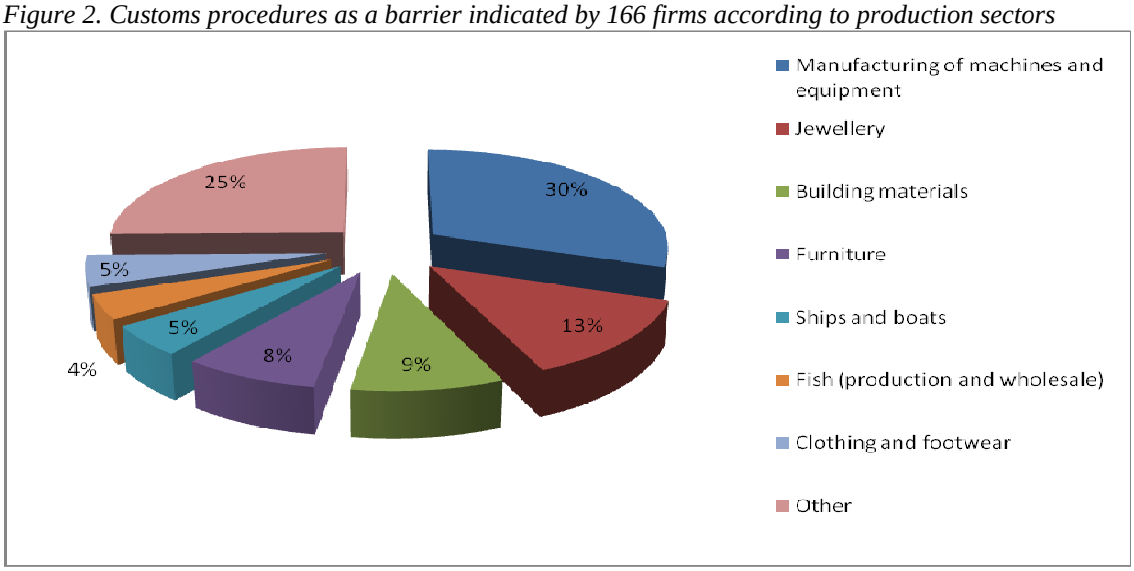
The average figures provide evidence supporting those findings. The enterprises suggest the barriers preventing expansion of exports to Russia is related to the fact that Russia is not a member of the WTO.

Tariffs and customs procedures

World trade has recently witnessed the lifting of MFN *ad valorem* duty rates below 4% on average and tariff binding. The principles of estimating the customs' value of a good are also important; the procedure ought to be neutral and should not increase the duty following the good's incorrect classification. Moreover, the customs procedure should not limit the trade as a result of unnecessary, complicated, and time-consuming requirements concerning the import documentation (bureaucracy).

Nonetheless, customs procedures may become non-tariff barriers to trade if the customs authorities misclassify a good or overestimate its value. Thus, in order to reduce the area of subjective customs' procedures, the WTO provides regulations for customs valuation and classification of goods. Customs classification is particularly favourable to trading partners (much more so than the valuation) since it involves application of an international classification system. It reduces the uncertainty concerning the qualification of goods by customs authorities, which is particularly important in the case of close substitutes that may be subject to different rates of duty. As a result, the use of a coding system, which strictly defines the requirements concerning the production process and packaging, reduces the expected duty. Naturally, even the agreement concerning the customs valuation or pre-shipping control is not a panacea for corruption, using incorrect basis for customs valuation of a given imported good, invoicing fraud, or increasing freedom in applying regulations to own customs procedures. Nonetheless, the implementation of a customs valuation system consistent with the WTO agreement requires automatisation of customs administration, improvement of infrastructure, staff training, etc.

Figure 2. Customs procedures as a barrier indicated by 166 firms according to production sectors



Source: as in Figure 1, p. 105.

Customs procedures in Russia are perceived as the most significant barrier limiting access to this market. When analysing the evidence by industry (see: Fig. 2), it turns out that customs procedures, indicated by 166 respondents, are considered the heaviest burden for the manufacturers of machines and equipment (30%), jewellery (13%), building materials (9%), furniture (8%), ships and boats (5%), clothing and footwear (5%), and fish products (4%).

Membership in the WTO seems to be a remedy for those practices. This is especially true because the average levels of MFN tariffs in Russia are higher than in medium-developed countries and much higher than in OECD countries. The structure of Russian tariffs is rather diversified. The average level of MFN tariffs in 2008 was estimated at 10.8%, whereas the average weighted with the volume of trade (in 2006) amounted to 11.4%, with the tariff on agricultural produce at a level of 14.2% (22.8% as a weighted average), and on the non-agricultural goods – at 10.2% (9.3% as a weighted average). The tariffs for agricultural produce are significantly higher than those for manufactured goods. From the perspective of an exporter's competitive position, it is thus essential to apply an appropriate customs classification. Among the MFN tariffs for imported agricultural produce, the most frequently used ad valorem tariffs (applied to 37% of imported goods) were below 5%, and the less frequently used ad valorem tariffs included: 5-10% rates applied to 11% of imports, 10-15% rates applied to 30% of imports, 25-50% rates for 5% of imports, and the highest 50% rates were used for 3.5% of imports. In the case of non-agricultural goods, the MFN rates were used as follows: below 5% ad valorem rate for 35% of imports, 5-10% rates for 15% of imports, 10-15% rates for 20% of imports, 15-25% rates for 16% of imports, and the 50% ad valorem rate for only 0.3% of imports. The average MFN tariffs and maximum rates of duty for individual groups of commodities are presented in table 1.

Table 1. Average and max MFN Russian tariffs of different product groups in 2008r.

Product group	Average MFN applied duties	Max applied duties
Animal products	21,5	134
Dairy products	5,5	25
Fruits, vegetables, plants	12,0	45
Coffee, tea	10,4	41
Cereals and preparations	14,6	116
Oilseeds, fats and oils	8,1	37
Sugar and confectionary	19,0	85
Beverages and tobacco	44,4	456
Cotton	0,0	0
Other agricultural products	6,7	31

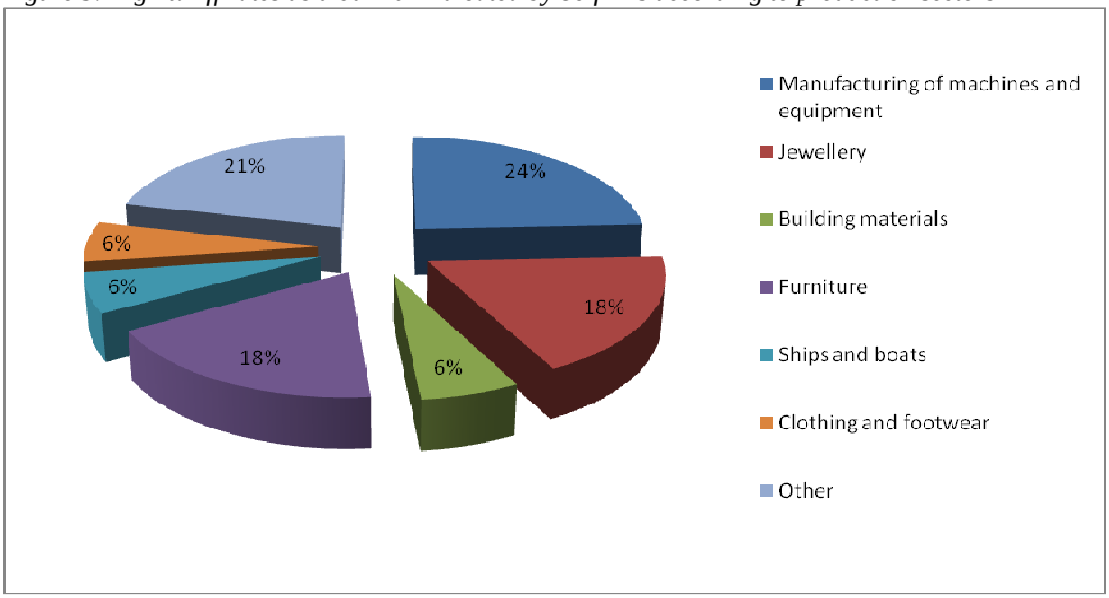
Fish and fish products	13,5	175
Minerals and metals	10,1	29
Petroleum	4,5	5
Chemicals	7,0	29
Wood, paper, etc.	15,5	87
Textiles	12,0	56
Clothing	20,2	59
Leather, footwear, etc.	11,0	91
Non-electrical machinery	4,2	27
Electrical machinery	8,8	45
Transport equipment	10,4	25
Manufacturers, n.e.s.	13,5	218

Source: Tariff Profiles WTO 2009, WTO Secretariat, Geneva 2010.

Among Russia's problems, two are of particular significance to the analysis: "tariff chimneys" and the fact that many tariffs are "specific" tariffs, defined as fixed amounts expressed in euro per quantity of the product, for instance 1 EUR/kg. For this reason each appreciation of the euro increases the ad valorem equivalent of the specific duty. Moreover, approx. 10-15% of tariffs have a form of compound tariffs. In this case the tariff is expressed as a combination of an ad valorem duty and a specific duty; in practice, the higher of the two is applied to imports, e.g. the ad valorem rate for soft cheese is 15% but not less than 0.5 EUR/kg. In general, the highest tariffs are applied to food and light industry products.

In the group of the analysed enterprises from the Pomeranian Voivodship, 80 point to the problem of high tariffs, of which 24% are manufacturers of machines and equipment, 18% manufacture jewellery, 18% manufacture furniture, and 6% each manufacture building materials, clothing and footwear, and ships and boats (see: Fig. 3).

Figure 3. High tariff rates as a barrier indicated by 80 firms according to production sectors



Source: as in Figure 1, p. 107.

As a result of the negotiations concerning accession to the WTO, Russia made a commitment to reduce its MFN tariffs to an average level of 8%, which implies an approximate 50% reduction in existing tariffs. In the case of many products, such as those delivered by the civil aviation industry, the reduction would range from 20% to 7.5%. For building and agricultural machinery as well as R&D and medical equipment, the reductions would amount to up to 5%.

In June 2009, however, the Russian government announced the increase of many tariffs to be expected in the years 2010-2012. Russia – discouraged by the lengthy (nearly twenty years) procedure of applying for membership in the WTO – is now delaying the process itself, which provides the country an opportunity to manoeuvre using trade policy measures, including customs policy. It involves growths in tariffs for many imported goods in 2010. The tariffs for raw materials and semi-finished goods, meanwhile, will be reduced. In the years 2011-2012, in turn, tariff reductions are to be applied to imports of hi-tech goods. The aim is to simplify and accelerate the importing and exporting of innovative goods and introduce tax exemptions for the Russian export of goods developed by innovative enterprises, which remain unprofitable under the existing system. The action is directly related to the implementation of the "Innovative Russia" package of bills. The changes refer also to the export tariffs for many Russian products. For instance, the middle of 2010 saw an increase in the tariffs for exporting mineral oils and painted or preserved raw wood (from 15% to 25% ad valorem but not less than 15 EUR per cubic metre).

Significant increases in import tariffs, on the other hand, were reported mostly for pig livestock, since in early 2010 the Russian government raised the tariffs from 5% to 40% ad valorem to protect domestic farmers. This growth was partially balanced with incidence (price reductions made by exporters, including those from Poland), and partially with the devaluation of the euro in relation to the ruble and the US dollar. In Poland, however, those operations resulted in a dramatic fall in exports of livestock – from 4.9 million in the first quarter of 2009 (USD 28 billion on an annual basis and the 4th position after Lithuania, Germany, and Estonia) to 147 thousand in the first quarter of 2010. Other exporters to this market reported less significant declines in their shares (or even increased their shares considerably, which was the case for Latvia). It is estimated that Russia's protectionist policy regarding pork led to a 33% reduction in imports of livestock, mostly at the expense of Polish exporters, but this result still does not satisfy the expectations of Russian producers.

Other problems related to trade with Russia may be traced to an event that took place on the 1st of January 2010 when a Customs Union agreement was signed between Russia, Belarus, and Kazakhstan, thus establishing the Eurasian Economic Community (EurAsEC). The countries share unified customs tariffs, a unified system of customs regulations, identical requirements concerning licences and concessions in foreign trade, and a Customs Code that came into force on 1 July 2010. The mechanisms regulating the activity of the customs union are to be introduced by the end of 2010 although the process of adjusting the regulations to those in force in the member states will be a difficult task. Nevertheless, there are still doubts as to the final effects of establishment of this union since the attempts to integrate Russia and Belarus, as well as Russia and Kazakhstan, had already been made in the past and the final results left a lot to desire.

Quotas, phytosanitary norms, technical standards, etc.

A general problem in the trade with Russia may be perceived in its new decree on the Food Security Doctrine, which came into force on 30 January 2010. This decree aims at the development of the domestic production of good-quality, safe, and cheap food while reducing the dependence on imports. The share of domestic production to be achieved in 4-5 years is estimated in relation to the total annual consumption for individual agricultural markets (95% for grain and potatoes, 90% for milk and dairy products, 85% for meat and salt, and 80% for fish products, sugar, and vegetable oil). For instance, as early as in 2009 imports accounted for only 25% of the total annual consumption of poultry. At the same time, numerous barriers were introduced to reduce the competitiveness of imports and support the domestic production of food instead. Since 2007, a system of two parallel kinds of quotas has been in force: import quotas (e.g. in 2010 the quota for poultry was set at 780,000 tons, for pork at 500,000 tons, and for beef at 560,000 tons), and tariff-rate quotas for meat (e.g. within the quota, the tariff on poultry amounts to 25% but not less than 0.2 EUR/kg, and above it – 80% but not less than 0.7 EUR/kg; the figures for pork amount to 15% but not less than 0.25 EUR/kg and 75% but not less than 1.5 EUR/kg, within and above the quota respectively, whereas for beef: 15% but not less than 0.2 EUR/kg and 50% but not less than 1 EUR/kg, respectively). What is important, the level of quotas in the cases of poultry and pork was reduced in relation to the preceding year whereas the quota for beef was increased following the problems in this market. The application of quotas distorts the picture of competitive advantage, which becomes less

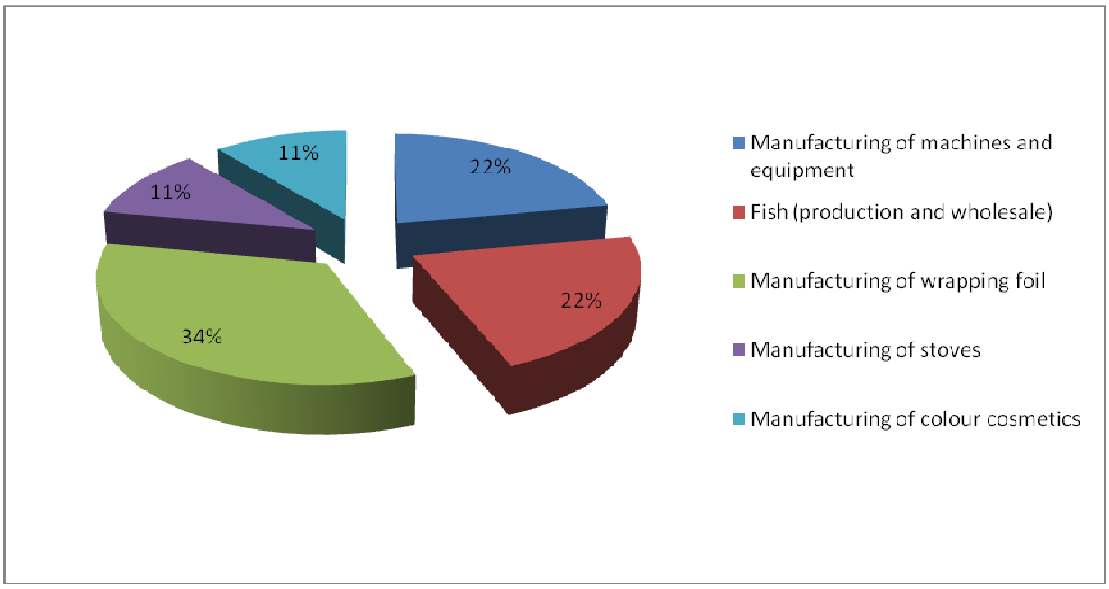
transparent and more susceptible to administrative wrongdoing and corruption. Moreover, the WTO generally bans their use; the major objective of the member states is to prevent their implementation. However, many countries still apply them, especially in relation to agriculture.

Sanitary, phytosanitary, and veterinary regulations are another form of intervention. The government imposes these measures in order to protect the health of people, animals, and the natural environment. They cannot, however, be used as trade restrictions, especially in the form of strict and expensive sanitary, phytosanitary, and veterinary criteria. The WTO agreement aims to limit any wrongdoing related to the implementation of those criteria, and particularly the inspection of the imported goods, which may be used as an excuse for rejecting certain goods that satisfy the safety criteria yet are politically sensitive. The sanitary and phytosanitary criteria set by the WTO significantly reduce the scale of protectionist overuse of health and safety of food.

Nevertheless, the Russian Federation, which remains beyond the WTO structures, applies independent solutions to this problem. Since 1 June 2009, it has been obligatory to attach safety certificates to exported apples and Chinese cabbage. Since 1 October 2009, those certificates have been also required for tomatoes, strawberries, and cherries, and since 1 March 2010, finally, the certificates are also required for pears. Furthermore, a list has been made of approved exporters of meat products, diary products, poultry, eggs, pig and bovine livestock, etc., who satisfy the requirements of the Russian veterinary control and are allowed to export their products to Russia. However, even the presentation of a relevant certificate does not imply the right to apply time limits for those enterprises listed among approved exporters in the case of products that are subject to veterinary supervision. As a result, even the exports of poultry from the United States were banned at the beginning of 2010, and it was not until the US president Obama intervened to Russia's president Medvedev that the ban was lifted. Considering the fact that Russia is the strongest partner in the new Customs Union (Russia, Belarus and Kazakhstan), even EurAsEC's coming into force will not eliminate the possibility of Russia's temporary interventions protecting its domestic market for agricultural produce and food, especially considering the doctrine provides a list of 53 groups of sensitive products.

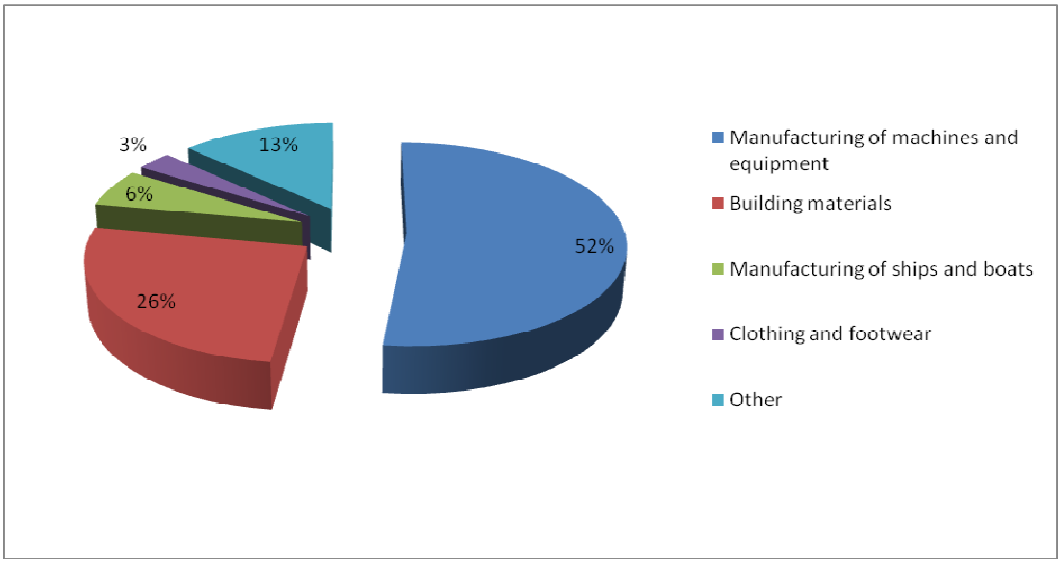
As a consequence, it is difficult to evaluate what impact the food security doctrine might exert on the growth in exports of Pomeranian enterprises to the Russian market. It will without doubt be a result of the domestic production self-sufficiency indicators achieved by Russia and changes in the size of the Russian domestic market on the one hand, and the competitiveness of foreign producers and efficient promotion of Polish products, including those from Pomerania, on the other. It would be also important to appeal to the WTO regulations, which allow questioning of a decision made by customs, sanitary, veterinary, or agricultural authorities as those regulations set certain standards yet leave to the members a certain freedom to modify them on the condition that other members are notified of any such deviations and appropriate justification is presented.

Figure 4. Sanitary and phytosanitary barriers indicated by 24 firms according to production sectors



Source: as in Figure 1, p. 110.

Figure 5. Technical standards as barriers indicated by 35 firms according to production sectors



Source: as in Figure 1, p. 110.

The research shows that the phytosanitary norms and technical standards are particularly painful for certain industries represented by the analysed enterprises. The phytosanitary barriers thus seem to be the most important obstacle for the producers of wrapping foil (34%), whereas the producers of machines and equipment (52%) argue that it is technical standards that make the trade so difficult (see: Fig. 4 and 5).

Product standards, technical norms, and certification systems play extremely important roles in the proper functioning of individual economies. They include widely accepted regulations, standard procedures, or legally binding technical norms and certificates, which prove they are met. The objective of introducing those technical standards and norms is to ensure the compatibility of goods and their quality. The standardisation is beneficial to all the parties involved, but the norms may become a barrier to trade, particularly if enterprises or the whole industries implement more strict requirements for meeting a standard, and especially if they are meant to reduce the competitiveness of imports. Governments often succumb to domestic lobbyists when they set technical norms. The aim of the WTO "Agreement on technical barriers to trade" is to ensure that the standards, technical norms, and certification systems in member countries are not applied in a manner that would constitute a means of arbitrary or unjustifiable discrimination between

countries or a restriction on international trade. Those requirements should ensure transparency (publication of regulations) and prevention of possible wrongdoing, and ought to be based on appropriate international standards. And again the procedures concerning the certification norms and requirements of the Russian Federation may and do significantly differ from the regulations obliging WTO members, leaving a lot of freedom in those matters.

State-owned trade enterprises (common in Russia) pose another threat to the WTO system since they may evade the principles of the Most Favoured Nation clause and apply measures discriminating their trade partners while making decisions concerning their purchases or sales. They may exert a similar impact to the introduction of taxes (tariffs) or subsidies. Each enterprise with a dominant position in the market and favoured by the central administration may reduce the competition. In this way the trade is distorted and its efficiency falls. Usually the WTO members, i.e. market economies, require from the new member a significant progress in the privatisation of enterprises and development of a market-oriented legal environment.

The Russian Federation is still careful about opening its market to foreign competition. The liberalisation of trade as a result of joining the WTO raises resistance among the groups that have thus far been protected by the domestic trade policy. The major opponents may be classified into four basic groups. The first group includes Oleg Deripaska – the tycoon in the aluminium industry, and production of vehicles and aircrafts – who is in favour of the existing infant industry trade policy. Similarly, the Russian Chamber of Trade emphasises that exports of Russian primary commodities, whose demand is rising, remains unthreatened so the liberalisation of the trade policy is useless. The Chamber strives for applying the infant industry policy to the food-processing, pharmaceutical, chemical, and electronic industries. Strong opposition is also observed in the agricultural sector, although Russia has been so far subsidising its agriculture to a limited extent only. The renaissance of agricultural production – in the opinion of agrarian societies – requires a focused support; the sector is expecting higher subsidies, which may translate into a growth in agricultural produce and its exports. For this reason, the accession to the WTO, which will reduce the subsidies for agriculture to a minimum, causes resistance. Another issue is also the specific sanitary requirements applied by veterinary services to imported goods, which leads to reductions in the imports of: poultry, pork and beef from the EU, including Poland, Ukraine and the US; fish from Latvia and Norway; diary products from Lithuania and Ukraine; and wine and fruit from Georgia and Moldova. Those measures should be considered as highly protective (although they are also applied by many other countries). The last group of opponents who are against the liberalisation of trade within the WTO includes the representatives of the Russian services sector, especially those concerning intellectual property rights (internet piracy), retail, telecommunication, banking and insurance.

The relevance of Russia's membership in the WTO to Pomeranian enterprises

The evaluation of Pomeranian exporters' operations was designed to learn about their plans concerning their future operations and expansion as well as their preferences related to the Russian market.

The problem of Russia's membership in the WTO is more complex than a mere discussion on the barriers applied by the country. In the questionnaire, all 308 enterprises answered the question "*Would Russia's accession to the WTO, imposing an obligation to respect trade agreements and liberalisation on all its members, facilitate trade with Russia?"* This implies that the Russian market is in the centre of attention of all exporters from Pomerania.

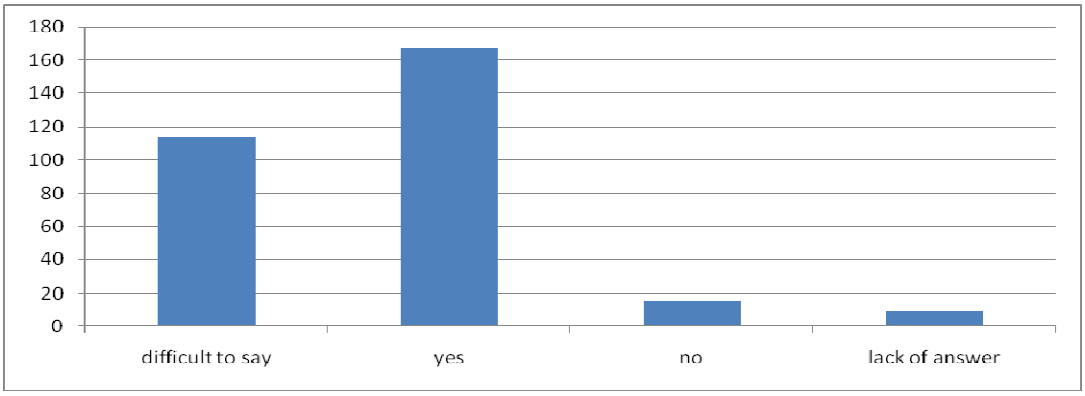
So taken all the above difficulties in this important market into consideration, the efforts aimed at Russia's accession to the WTO should be supported. It will force the Russian government to desist from interventions in their trade policy in favour of a more open and market-oriented approach.

There is no doubt that the situation of Polish exporters would significantly improve if Russia joined the WTO structures. On the other hand, Russia's membership in the Organisation may not meet all the expectations. Experts emphasise that the sanctions imposed on Russia's exports (if Russia becomes a member of the WTO; and according to the Organisation's regulations) in "revenge" for its strict import regulations may turn out to be inefficient. It results directly from the commodity structure of Russian exports, which is based mostly on oil and natural gas, steel, iron ore, coal, metals, and chemical products. As a consequence, during the Polish-Russian "meat war" several opinions could be

heard: optimists claimed that Russia's accession to the WTO might improve the situation; pessimists expressed doubts as to this improvement. Several arguments supported the pessimistic opinions. First, if the EU filed a case concerning such an embargo with the WTO, the trial would be lengthy. Second, even if the EU won the case and Russia failed to obey the ruling, the Union would be unable to impose any sanctions on Russia since it exports neither processed goods nor agricultural produce to the EU. And who would be willing to place restrictions on exports of the Russian oil and natural gas?

The guarantees perceived by Poland and other members in relation to Russia's accession to the WTO will therefore depend on the degree to which the Organisation will be able to force its new member to obey the common regulations.

Figure 6. Importance of Russian membership in the WTO for Pomeranian firms



Source: as in Figure 1, p. 113.

There are many studies undertaken by institutions and think tanks that demonstrate the broader economic consequences of having Russia outside the WTO.

This research carried out among Pomeranian entrepreneurs reveals that they face numerous barriers in the Russian market and the majority of respondents postulate that Russia should join the world trade system (see: Fig. 6). From the perspective of Pomeranian enterprises, Russia's aspirations to join the WTO should be welcomed, the more so because it will be followed by a gradual implementation of major reforms in the country's trade policy.

Similar research results were obtained by the authors in their questionnaire survey carried out among the members of the Gdansk Business Club in March and April 2009. The same regularity was also found in another questionnaire survey conducted by the authors together with MBA students of the University of Gdansk in April and May 2010 among 139 enterprises from all over Poland.

The conclusions seem, therefore, to be unanimous. From the perspective of Pomeranian entrepreneurs the government should be lobbied to support the membership of the Russian Federation in the WTO since it will benefit Pomeranian exporters through more access to this market and transparency of operations.

In general, the most important results of analysis is that countries from the region should establish a coalition to support Russian accession to the WTO. It may be a way to reduce trade barriers and benefit businesses of all parties. It should be perceived as a necessary element of normalcy in a mutual relationship since key decisions Russia had to make included determining the level at which to liberalize tariffs and non-tariff barriers. It will also comprise the elimination of significant levels of protection due to Russia's complex system of standardization to serve more transparency and clarity in their trade policy.

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A Baltic Tiger in a Gilded Cage – A Schumpeterian View on Innovation Policy in Estonia

"If I see a company coming out of Estonia I am reasonably assured that it will be executed well. That is because there is a lot of Skype alumni in Estonia. For its size, Estonia is generating more high quality startups than you would expect"

(Naval Ravikant, founder of AngelList)

I Introduction

Liberalization as the main concept of the last two decades guaranteed a fertile culture for Estonia's catching up. Seen from an entrepreneurial perspective, this might have been the best choice in order to empower *all kinds of entrepreneurial forces* (mainly in the sphere of non-innovative behaviour) that have been blocked for decades. But improving the direction of development by political influence would now require abandoning the powerful free trade doctrine in order to prepare the soil for *innovative* entrepreneurship that will be needed for a forthcoming upswing period. This thesis can be directly related to the way innovation occurs at the company level in Estonia (innovation as outsourcing, cost-cutting machinery acquisitions, etc.): "financial fragility in effect locks these small economies into specific innovations that target low value-added sectors and activities" (Kattel 2009, p. 15). Some efforts have already been made to establish a more innovation-oriented policy approach since 2000 by targeting public and private R&D activities, strengthening the instituitional bases, and break-out from a free market innovation approach. There is now a pressing need to take account of Estonia's traditional sectors "with major sources of employment such as wood processing, furniture, textiles, clothing, and radio, TV and communication equipment all losing competiveness rapidly" (Reid/Walendowski 2006, p. 31).

Considering this background, we want to analyze the current status of innovation policy in Estonia. Our main research questions will be: how can a policy approach provide a process of Minskian hedging in order to stabilize a Schumpeterian process of economic development? Is Estonia (or the Baltic states in general) threatened to stick in this crisis due to a lack of "hedge positions," i.e. a "strategy of innovation" (Röpke 1977), or is there something like a natural path of an unstoppable upward for Estonia due to the liberal market environment?

II Innovation Policy and Economic Development in Estonia

In 1939, Estonia and Finland had very similar standards of living. In 1987, however, Finland's GDP per capita was about $14,370, compared to Estonia's GDP per capita of about $2,000. This "welfare effect" that happened under the Soviet Union's socialism is well known and can be explained, of course, by the decades-long lack of capitalist dynamics. But what has happened in Estonia after the institutional restructuring of Eastern Europe in 1990? Interestingly, after regaining independence, inflation was rampant in Estonia; real wages fell below $2,000 per capita and almost 90% of the country's international trade depended on Russia (Laar 2007, p. 2). Since then, Estonia became something like an economic lab of liberalization. Estonia established radical reforms, allowing Adam Smith's "invisible hand" to bring prosperity by establishing an entrepreneurial culture, a sound currency, and a balanced budget. Furthermore, subsidies to state-owned companies were cut, property reform and privatization opened the economy, tariff and non-tariff trade barriers were eliminated, and the tax system was reformed to a simple flat tax (the first in the world[1]) on January 1, 1994 (Lumiste, Pefferly and Purju 2008, pp. 3).[2]

[1] For a detailed discussion of the theoretical, historical, and political background for implementing Estonia's flat tax, see Laar (2007, pp. 9).

[2] Despite of the fact that regional disparities occurred already at the very beginning of the transition process and the new government, the few regional policy measures (regional tax reductions etc.) were cut off, because they no longer fit the laissez-faire ideology (Kuura 2006, p. 467).

II.1 A Lab of Liberalization: The Rise and Fall of Estonia's Economy

Estonia became "off the cuff" one of the freest economies in the world[3] and in 1993-1994 the forgotten spot in the world became a "mekka" for FDIs. Privatization (completed by 2000-2001) and liberalization opened the door for the inflow of foreign investments. Beside this financial influx, FDIs also became a source for a new business culture, marketing skills, and technical knowledge (Lumiste, Pefferly and Purju 2008, p. 33). Consequently, this development was accompanied by new working places and the reconstruction of old factories (Laar 2007, p. 6).[4] The openness of the Estonian Economy – measured by the ratio of exports to GDP – was between 40-50% in the 1990s and peaked at 58.5% in 2006 (Lumiste, Pefferly and Purju 2008, p. 24). "Estonian enterprises had to substantially change the character of their products. Many enterprises changed from being manufacturers of final or semi-final products to being subcontractors of Western firms [especially in Finland and Sweden]. Raw materials (unprocessed wood, scrap metals, textiles, and agriculture) formed a very large share of Estonian exports" (ibid, pp. 24). In 1999, Estonia became a member of the WTO and the supply of finance available to enterprises and consumers from banks increased considerably with changes in bank ownership, falling interest rates, and a widening range of financial products (Smallbone/Venesaar 2003, p. 77). The most attractive area for foreign investments during the period of 1995-2006 have been real estate, renting, and business activities with 29,8%, financial intermediation 28,1%, and manufacturing 17,5% (Lumiste, Pefferly and Purju 2008, p. 13), resulting in short-term boom effects, but hindering the rise of a long-term innovation strategy (see below).

However, the results of this experiment have astonished the world: An 8% average annual GDP growth since 2000 (until the financial crisis), a strong decrease in poverty and inequality, low unemployment, low inflation, and rapidly improved living standards can be seen as a proof of a successful "catching-up" strategy. The government's budget was not only balanced, but it ran a strong surplus, and many new, export-oriented factories were established. This boosted competition and led to modernization. The free market doctrine reigned (and still reigns), and Estonia liberalized its capital movements even further than required by EU accession (Lumiste/Pefferly/Purju 2008, p. 19). Furthermore, due to the Free Trade Agreements with Finland and Sweden, replaced later by the Free Trade Agreement and Association Agreement with the EU, the trade with Western Europe made up two-thirds of trade in the 2000s and Estonia received EU membership.

But the crisis hit Baltic States hard. As we have shown, the crisis can be interpreted as a Schumpeterian problem of simultanous downswings, which occurred by the fall of the 5th Kondratieff (Otter/Siemon 2012, in this volume). The stable ground of a free market strategy allowing an enourmous influx of FDIs "created highly fertile grounds for short-term asset booms and so particulary during the early 2000s, large amounts of foreign investment and private lending went into financing of consumption and real estate booms" (Kattel 2009, p. 10). Kattel illustrates that the Baltic states have moved into a situation of speculative (maybe widening to Ponzi) financing: "The small open [Baltic] economies were flushed with foreign capital, became quickly overleveraged and are now paying the price" (ibid, p. 1). From an evoutionary standpoint, Estonia's catching-up process was led by learning processes, imitation effects, and input-led growth as a by-product of more or less non-innovative activity. We suppose that the catching-up process will be further blocked if no self-created entrepreneurial activity can be achieved. This kind of "learning" will be particularly important in order to cope with intrinsic problems of secondary wave effects that follow a Schumpeterian downswing. The GDP in Estonia fell by 3.6% in 2008 and a further 14.1% in 2009. Unemployment is currently at 18.6% (second quarter 2010). Despite these hardships, however, the Estonian government kept budget deficits low, and Estonia joined the euro zone on January 1, 2011.

Seen from a Schumpeterian standpoint, liberalization guaranteed, of course, a certain culture of seed for catching-up during the last two decades. This kind of "big-bang-transformation" after the collapse of the Soviet Union, might have

[3] In the Index of Economic Freedom, Estonia in 2007 was, despite certain constraints from EU, still the twelfth freest economy in the world. In 2002 it ranked fourth!

[4] In this context the Department of Foreign Trade of the Ministry of Foreign Affairs played an important role in the harmonization of legal acts related to international trade. Furthermore, it acted as a coordinator of measures to integrate Estonia into the EU and the WTO and to build relationships with, for example, the European Free Trade Association (EFTA). Lumiste, Pefferly and Purju (2008, P. 18) state that the "Department has been the most liberal of all the institutions that influenced the regulations of foreign trade."

been the best choice, thereby causing an increase in productivity in fields once belonged to the low-productivity legacy of the Soviet period (Tiits et al. 2003, p. 16).[5] Those entrepreneurial forces lay fallow, and have been released to typical learning processes within a process of catching up (see Abramowitz 1986). Hence, the lab of liberalization generally has helped to establish a vital atmosphere of entrepreneurial activities.[6] This way of development seems to be typical for transition countries in general, as MacMillan/Woodruff (2002, p. 168) state: "The entrepreneurs in the transition countries exemplify Smith's dictum [of the invisible hand]. By creating jobs, supplying consumer goods, constraining the market power of the state firms and building reform momentum, they have produced real welfare gains." The region is still one of the easiest places in the world to start up a business, requiring only 6.2 procedures on average to register a new company. Furthermore, the Baltic Sea region generally grants its employers great flexibility in hiring and firing their workforce (Varblane/Mets/Andrijevskaja 2010, p. 8). The economy still benefits from a strong electronic and telecommunication sector ("E-stonia"). But successful firms like Skype, Playtech Ltd., Rate.ee or Helmes Ltd. are influenced strongly by the involvement of foreign partners. None of these projects have been started as a spin-off project by academic entrepreneurship "Made in Estonia" (Lumiste/Pefferly/Parju 2008, p. 36).

However, this entrepreneurial activity was more or less short-term and less innovation orientated due to the lack of a targeted Schumpeterian policy approach intended to establish long-term comparative advatages (see below). Schumpeterian effects of a secondary wave have occured in Estonia expounding that the growth processes were led by mainly non-innovative input impulses: "Thus, in the context of lowered risk-perception, abolished trade restriction, and aggressive lending activity by foreign banks, extensive use of easy credit drove economic expansion by financing consumption as well as real estate bubble, and resulted in skyrocketing asset prices that have enabled debt-led growth" (COSTAction 2011, p. 3). Furthermore, the Estonian economy became stuck in specializing in short-term comparative advantages due to FDI calculations: cheap labor intensive (textile) and resource intensive (timber) industries with only low innovative potential. Hence, from the very beginning of this catch-up process, the influx of FDIs created "highly fertile grounds for short-term asset booms" and led to "financial fragility," which "locks these small economies into specific innovations that target low value-added sectors and activities" (Kattel 2009, p. 15).[7] Although all political forces declared their support to business, sometimes even to SMEs, and private ownership became dominant, the influence of entrepreneurship policy has been rather modest (Smallbone/Venesaar 2003). Moreover, the entrepreneurial spirit in Estonia remained at a low level, as has been shown by international comparisons (Varblane/Mets/Andrijevskaja 2010, pp. 11)[8].

Despite the fact that the supply of finance available to enterprises from banks has increased considerably since 1994, access to capital by commercial banks in Estonia – like in every other country – was (and still is) very limited, due to

[5] An interesting case study shows how the Estonian company Tarmeko has been forced to change its entrepreneurial direction in the woodworking and furniture industry by immediate diversification and rapid restructuring. Upstream, the supply of wood and other inputs (paint, glue, rubber, etc.) from Soviet sources was almost completely cut and had to be replaced with hard currency purchases. Downstream, the whole distribution system collapsed. In a couple of months, the demand for the chipboard desks shrank from 500 a day to a couple dozen. Tarmenko rapidly traced a path of developing new products that international distributors were demanding, from very simple products (e.g. wooden chairs) to more sophisticated products (e.g. leather sofas). In 1993 Tarmeko sold 88 % of its products mainly to Western Europe, while in 1991 96 % still had been shipped to the Soviet Union. This process of change management was accompanied by a management buy-out in 1994 initiated by the Estonian Privatization Enterprise (von Hirschhausen/Hui 1995, pp. 435). Tarmeko still exists - www.tarmeko.ee!

[6] In 2004, for example, the number of active enterprises was 40,627 and the number of active sole traders was 50,260 amongst the 1.4 million inhabitants in Estonia. Tallinn, the capital of Estonia, and its surrounding Harju county dominate the economic life of Estonia; more than half of Estonian businesses are registered there (Varblane/Mets/Andrijevskaja 2010, p. 13).

[7] See Kattel (2004, p. 402), who has already alluded to several statistical analyses that traditonal Estonian sectors have become more efficient since the early 1990s. From a dynamic perspective, however, the long-term innovation orientation has diminished: "While technological complexity has increased, the relative share of value added in the output of Estonian companies was greater in the year 1994 than in the year 2001." Furthermore, he has confirmed that "a substantial part of revenues and, correspondingly, of the higer wages and improved living standard generated by these effective agricultural and other resource-intensive Estonian producers, does not remain in Estonia or create any additional specialization in Estonia, but is transferred back from where the relevant technologies originated" (ibid, p. 405).

[8] See Varblane/Mets/Andrijevskaja (2010, p. 11), who refer to the Global Entrepreneurship Monitor's concept ("Total Entrepreneurial Activity Index") and state that this index in Estonia is very low. The level of subsistence entrepreneurship, however, "is low as well and reflects the advancements also in the level of income in Estonia. The position of Estonia is rather typical for a country with the upper middle income level". Furthermore, they refer to other surveys illustrating that Estonia's population in general is not highly interested in becoming an entrepreneur, thereby giving Estonia the position at the very end of a long list of countries.

insufficient collateral and a lack of a track record (Smallbone/Vanesaar 2003, p. 77). The Estonian system of formal venture capital industry has developed significant problems during the last two decades.[9] There is not a sufficient number of competent seed and start-up investors in the formal and informal financing sector. This is mainly due to the fact that the history of the venture capital market providing seed and start-up capital for innovative firms is quite short. Most investments are channeled into growing companies and seldom into start-ups. Venture capital firms as well as business angels are reluctant to support local RTDI business projects due to the high risks (Nedeva/Georghiou 2003) due to a lack of fruitful entrepreneurial compencies in the financial sphere. These types of investment are not only important for providing capital, but for their evolutionary effects by acting as a sounding board and giving feedback to entrepreneurs (Siemon 2006). The well-known successs story of VC investing in Estonian knowledge-based economy is Skype, which was financed by foreign investors and sold to eBay for 4.1 billion US dollars in 2005. Skype's technology is based on software created by four Estonians and commercialized by a Scandinavian team. Interestingly, still no scientific survey about the amount and quality of a vital business angels market in Estonia exist at all. This is probably due to the fact that Estonia has failed to establish the necessary culture of financial entrepreneurship by recycling the capital and entrepreneurial experience from entrepreneurs who have been successful during the 1990s.[10]

However, the structure of the VC industry has become more organized. In 2009, the Estonian Venture Capital Association (EstVCA) has been established (nudged by the Estonian Development Fund) as an umbrella organisation for Estonian VC firms and business angels. Generally, however, the Estonian formal and informal Venture Capital has not been analyzed thouroughly.[11]

Well known theoretical aspects were adducted in order to provide financial support for innovative entrepreneurs due to their role as job- and growth-creating machines ("gazelles" in terms of Kirchhoff). Hence, an institutional framework for innovation policy has been established in the late 1990s in order to organize the responsibilities between the different political institutions regarding planning innovation oriented programmes (see figure 1).[12]

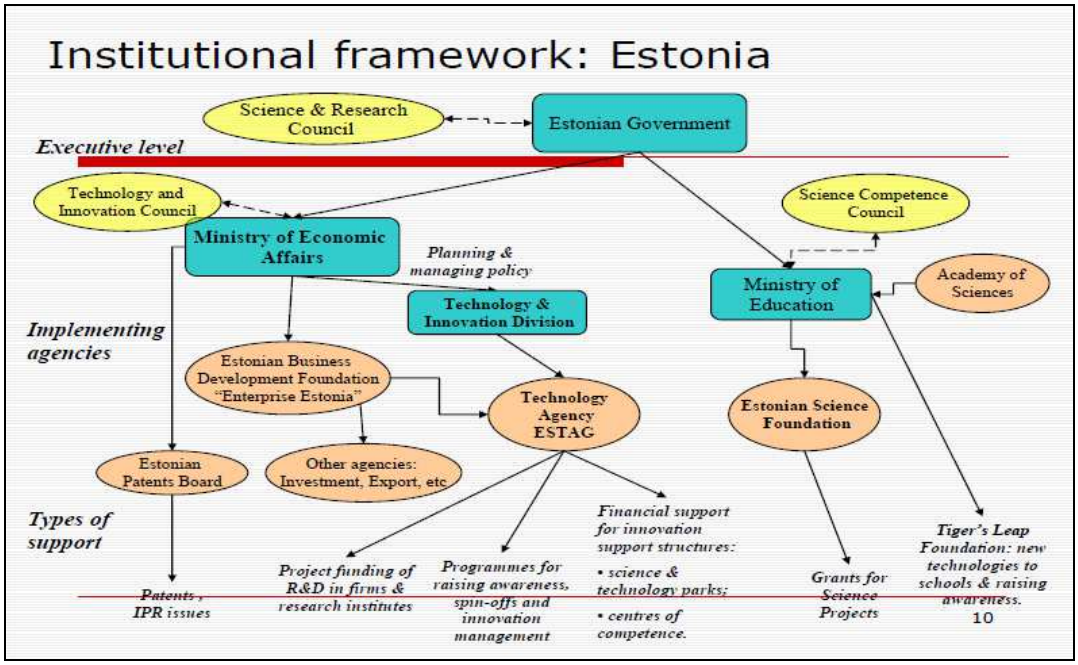
[9] According to a study of EVCA, the private equity investments amounted in 2005 just to 0.004 percent of GDP in 2004, whereas the average percentage in Europe was at 0.32%. In 2008 (0.088%), the picture remains nearly the same (2007 the Estonia Development Fund was established, thereby the data amounted 0.332%). Estonia is at the bottom of private equity investments in Central and Eastern Europe, just leaving Slovakia, Slovenia, Serbia and Bosnia&Herzogowina behind. This might be one hint for an underdeveloped venture capital industry (accompanied with a strong need and desire for foreign direct investments). From a Schumpeterian standpoint, however, the role of financing innovations is not just a matter of quantity, but of quality (cp. Siemon 2006).

[10] See Varblane, Mets and Adrijevskaja (2010, p. 28): "The basis for private venture funding raised as the result of sale of own successful companies by entrepreneurs established businesses (...). Mainly these entrepreneurs have invested afterward their money into new businesses of the same sector they were experienced. That means, although, 15 years after starting private business there is not the big number of grown in Estonia investors having competency in knowledge-based entrepreneurship"

[11] A study of Köomägi and Sander (2006), based on detailled theoretical background, has shown that, for example, the small VC market in Estonia does not offer the opportunity to use syndication. Furthermore, traditional concepts of staged and convertable investments are used rarely and complicated financing structures in the stages are used seldom.

[12] The figure contains older denotations in terms of "Ministry of Education" (now: "Education and Research") and "Ministry of Economic Affairs (now: "Economic Affairs and Communication")

Figure 1: Institutional Framework of Estonian Innovation Policy



Source: Varblane/Mets/Adrijevskaja (2010, p. 23; based on Reid 2003)

Estonia's process of catching up has shown some successful aspects since implementing this more innovation-orientated approach. Of course, it is difficult to measure the innovativeness of a state due to certain methodological, statistical and paradigmatical problems (neoclassical input-logic vs. Schumpeterian development-logic approach etc.). Due to the innovation approach of the Lisbon strategy, the European Innovation Scoreboard (EIS) has been published annually since 2001 to track and benchmark the relative innovation performance of EU states.[13] For Estonia, the innovation performance in 2008 was just below the EU 27 average but the rate of improvement is above. Estonia's relative strength are in finance and support, firm investments, linkages & entrepreneurship, and innovators, while relative weaknesses are stated in scientific throughputs (patents, trademarks, designs, etc.).[14] However, some problems of implementing the so-called "knowledge triangle" (education, research, innovation) still remain (Kirch 2010, p. 276). The period from 2000 to 2007 saw a rapid increase in GDP while it dropped in 2008. Estonian GDP was 45% of the EU average in 2000 and increased to 68% by 2008. The accumulation of human capital might be one important (input-logic orientated) aspect for developing countries to catch up to the EU average level, as Kirch (2010, p. 274) states. However, accumulation of human capital as an input-factor as well as entrepreneruship itself cannot be a lasting cornerstone of economic development if some kind of innovation (combining given factor endowments, e.g. R&D, natural resoruces in a new way) and evolution (learning skills how to innovate or being any other kind of entrepreneur) are lacking (see chapter below).

II.2 The Estonian Turnaround: From "No-Policy Policy" to Innovation Policy

Regarding innovation policy, Estonia has followed a policy of non-intervention during the 1990s: "Estonia has been an interesting case of the country, which has since regaining its independence moved ahead without having defined its innovation policy and one could define Estonian innovation policy as 'no-policy policy' (term proposed by Kalvet et al., 2002)" (Varblane/Mets/Adrijevskaja 2010, p. 20). The first watershed from the free market doctrine to an innovation policy approach, thereby covering different forms of financial and institutional interventions, can be registered in the late 1990s.

[13] The methodology hass been revised recently since the number of dimensions increased to seven (human resources and finance/support in the first group, "Enablers," firm investments, linkages/entrepreneurship and throughtputs within the second group, "Firm Activities" and innovators, economic effects within the group of "Outputs" (see e.g. EIS 2009, Kirch 2010).

[14] In EIS-report 2009, Estonia is called a moderate innovator ranking considerably in front of Latvia and Lithuania, their Baltic counterparts, ranking in the weakest group of innovation ("catching up countries") (EIS 2009, p. 8).

The entrepreneurship and innovation policy since 1990 can be characterized by the following milestones (cp. Kuura 2006; Smallbone/Venesaar 2003, Varblane/Mets/Adrijevskaja 2010, pp. 19; Karo 2010; Kirch 2010; Reid/Walendowski 2006; Kristapsons/Martinson/Dagyte 2003, pp. 139):

- From 1992 to 1998, the Swedish Organization NUTEK implemented a project called: „Support to Regional Development in Estonia through Business Development.“ The main aim of the project was to support the establishment of three regional business centres (Vóru, Viljandi und Jóvi) in order to stimulate private small business in economically depressed regions;
- In 1993, the EU PHARE programme started to support the Business Advisory Service (BAS) centres; four centres were established in major Estonian cities (Tallinn, Tartu, Narva and Pärnu). At the same time, the programme “Estonian Jobs and Society” (J&S) was started with Finish support and based on a concept that larger business would promote the establishment of smaller enterprises; thus four business centres were implemented in Tallinn, Harjumaar, Hiiumaa and Saaremaa;
- In 1994, the “State Support of Enterprise Act” was passed; it did not mention SMEs explicitly, but set out certain criterias that have been used since then, e.g. the number of 80 employees. The EU funded project “Technical Assistance for SMEs in Estonia” was implemented as well;
- The “Rural Development Foundation,” under the Ministry of Agriculture, was founded in 1993 in order to support economic development in rural areas by long-term loans, granting of leases, and specific support services;
- In 1997, the Estonian Regional Development Agency (ERDA) was established as an „umbrella“ organization. Its main tasks have been to implement the government’s regional programmes as well as the programme “Business Support Networks (BSN)” as independent but closely related and co-operating institutions;
- In 2000, “Enterprise Estonia”[15] (Budget 2005: 98 mill Euro) was introduced as a new “umbrella”[16] agency and the Estonian Credit and Export Guarantee Fund (KredEx) was founded as an institution to support SMEs’ financing situations and to decrease export-related credit risks;
- In 1998, the R&D Council initiated the work towards an “Estonian R&D strategy” collaboratively prepared by the Ministry of Education (now Education and Research), the Ministry of Economic Affairs (now Economic Affairs and Communications), and the Estonian Academy of Science. In 1999, the Estonian Science Foundation and the Estonian Academy of Sciences were accepted as members of the European Science Foundation (ESF), a pan-European body for promoting management and regulation of solid scientific practice in the European Research Area. In 2003, Estonia participated in five ESF research programmes (Kristapsons/Martinson/Dagyte 2003, p. 150);
- The major improvement of policy-level thinking started since late 1990s due to the aforementioned developments. Two documents about the Estonian innovation policy were prepared by the R&D Council, the ministries, and the Estonian Academies of Sciences in order to promote a set of general policy priorities (e.g. the improvement of quality of product and services, development of innovative products based on local R&D, creation of innovation networks): The Estonian State Innovation Programme (approved in June 1998) and the National Development Plan for the years 2000-2002 (1999). Unfortunately, neither of these were actually

[15] “Enterprise Estonia” (EE) was established due to some problems that arose by the policy path traced before. A PHARE report states that the plurality of private and public institutions (Chamber of Commerce and Industry, Estonian Small Business Association, Investment Agency, Trade Promotion Agency, Tourism Board) – additionally to BSN – involved in the process of supporting entrepreneurship were accompanied with problems of coordination and responsibilities. EE was started as a foundation subordinated to the Ministry of Economic Affairs and encompasses all aforementioned agencies, i.e. integrating ERDA in 2001. In 2003, the functional organized subunits of EE were reorganized into three divisions: the Business Start up Division, the Business Development Division and the Busines and Living Environment Division (Kuura 2006, pp. 469; Varblane/Mets/Adrijevskaja 2010, p. 23).

[16] Programmes like NUTEK or PHARE were relatively well financed, while others (e.g. J&S) were plagued by limited resources. Thus, the need to consolidate was felt in Estonia. (Kuura 2006, p. 468).

implemented due to the lack of resources (Varblane/Mets/Adrijevskaja 2010, p. 20; Kristapsons/Martinson/Dagyte 2003, p. 150);

- In 2000, the White Paper on the strategy of R&D in Estonia for 2001-2006 "Knowledge Based Estonia" was accepted by the government. Referring to this, R&D activities – partly financed by EU structural funds – were supported in order to establish a research, technology development, and innovation (RTDI) policy. The government prepared two related programmes (the inno-awareness and the spin-off programme). Thereby it became a commitment to Lisbon Strategy's requirements in order to preserve the European welfare model (cp. Rodrigues, 2003).[17] The Estonian Technology Agency (ESTAG) was founded in 2000 in order to implement this innovation policy. The Estonian strategy set out two main objectives: (1) Updating the pool of knowledge by raising the quality and level of scientific research and (2) increasing the competitiveness of enterprises. The implementation was done by four key lines of action (Reid/Walendowski 2006, p. 9):
    - Financing research and development, such as the increase in total expenditures on R&D from 0.9% in 2003 to 1.5% of GDP by 2008;
    - Development of human capital by reinforcing and complementing the national educational system strategy ("Learning Estonia");
    - Increasing the effectiveness of R&D and innovation systems by raising awareness, bridging structures between industry and research, supporting spin-offs, etc.;
    - International co-operation by strengthening Estonian participation in international R&D networks.
- The "SPINNO programe" was introduced 2001 for the enhancement of the commercialization capacities and activities of public research institutions. More specifically, it had the following objectives: (a) to increase the exploitation rate of the results of research carried out in Estonian universities and R&D instituitions, (b) to develop an evironment favourable to entrepreneurial activities in Estonian Universities and R&D institutions, (c) to develop co-operation between Estonian universities and R&D institutions in supporting knowledge-intensive entrepreneurial activity (SQW 2003, p. 1). EE and the Ministry of Economic Affairs and Communications (MEAC) provide grants in form of co-financing for public research institutes for the creation of spin-off organizations and capacities.[18] After the period 2001-2006, the programme has been continued for the period 2007-2013 (Brighton/Kells 2007);
- The R&D Financing Programme was established in 2001 (budget for the first period 2001-2003: 15.3 mill. euro) in order to support R&D activities in industry as well as research institutes. The programme contains three sub-instruments: (1) support for feasibility studies, (2) applied research support for R&D institutions, and (3) applied research and/or product development support and loans for companies (for an overview of the main conditions of granting support see Kalvert/Jürgensson (2009, pp. 3).[19] The objective of the renewed "Knowledge-based Estonia" strategy 2007-2013 is to increase Estonia's R&D investments by 2014 to 3% of the GDP;

[17] This was a result of reorganization of "The Innovation Foundation," the first, but hardly noteworthy, organization supporting R&D established 1991. The understanding of innovation policy was extended during 1990s from project-base activity to a more systematic understanding of innovation. In 2004, a strategy document "Estonian Success 2014" was passed containing the aim to double Estonian GDP by 2014, increase productivity by 80%, and increase employment rate up to 70% of labour age poulation.

[18] During the period 2001-2003, three projects have been provided at Tallinn University of Technology (TUT), Tartu University (together with Estonian Agricultural University and Tartu Science Park), and for BioSpinno as a sector wide project (including, for example, the Estonian BioCentre, Instititute of Chemical and Biological Physics, Tartu Biotechnology Park, and the Estonian Gene Centre); this was subsequently extended to seven projects during the second round of funding awarded in 2004.

[19] "The goal is to apply the developed technologies and innovations in business, thus increasing the effectiveness and improving the performance figures of the company implementing the project and the Estonian business sector on the whole" (EAS 2001, cited in: Kalvet/Jürgenson 2009, p. 3). Kalvet and Jürgenson have shown that input and output additionality of this programme turned out to be generally low without claiming to cut off R&D granting schemes, because of changes in enterprises' behaviour and entrepreneurial attitude. (ibid, p. 17).

- The Competence Centres Programme (launched in 2002) has become one of the main innovation policy measures in order to bridge the science and technology spheres of the innovation system. The need for a qualitative shift of core capabilities was established by eight centres including about 100 enterprises (mostly SMEs) and covering different fields of biotechnology (food, medicine), nanotechnology, ICT (hardware and software solutions), and machine technologies. The public budget for the 2007-2013 period is approximately 58 million EUR (Karo 2010, p. 189). Due to this, also some programmes of entrepreneurship education at universities, e.g. at Tallin University of Technology and Tartu University have been implemented during the last decade;
- The "Estonian Development Fund" started in 2007 as a think tank in order to lead Estonian economic restructuring and is based on the Estonian Development Fund Act (2006). Recently, it triggered the ambitious programme "Growth Vision 2018."[20]

In , the National Technology Programme started in order to concentrate the R&D support measures into areas in which Estonia has the potential to thrive in international competition. For this purpose, the Ministry of Economic Affairs and Communications, together with the Ministry of Education and Research, planned to launch state-level technology programmes in areas of national priority. The first state programme to be started was the national Energy Technology Programme (ETP).[21] In addition to the ETP, programmes in the fields of biotechnology and information technology have been or are about to be launched.

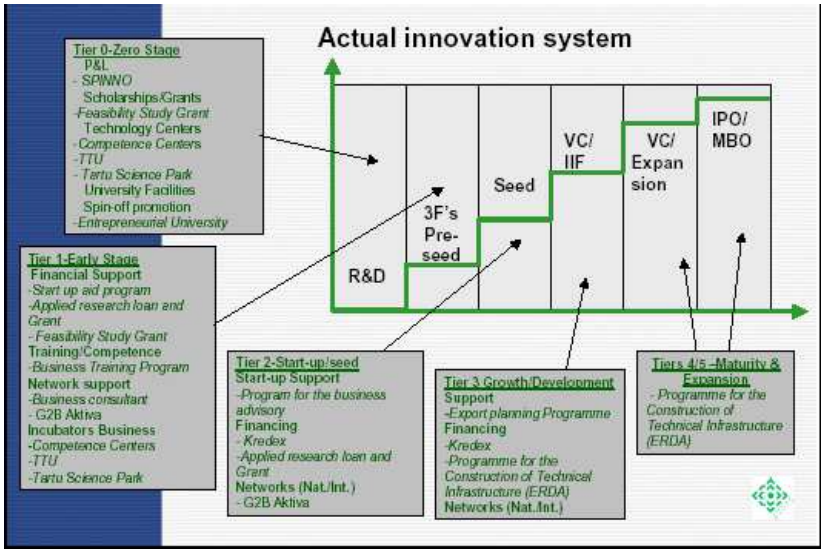
II.3 A Schumpeterian Evaluation: Short- vs. Long-Term Competiveness in Estonia

Especially the "Knowledge Based Estonia" strategy can be regarded as a milestone in Estonian RTDI policy: "It contributed to shifting attention of policy-makers from a 'laissez-faire' (free market) approach to economic policy towards the need to invest significantly greater public and private resources in boosting higher valued added activities" (Reid/Walendowski 2006, p. 12). Based on a firm's life cycle approach, the following (figure 2) illustrates how different kinds of innovation and entrepreneurship policies are targeted to the different tiers of a firm's innovation process. Thereby, the problems of financing innovations (and entrepreneurship in general) by public efforts can be viewed closer from a Schumpeterian standpoint.

[20] The public fund aims to do 6-8 investments a year and is targeted to early stage Estonian companies with an ambitous international expansion plan, a sustainable, unique competitive advantage, a strong team, scalable technology/business model, and a clear exit path. Furthermore, investments into foreign companies are possible, provided their headquarters are established in Estonia and if they bring R&D activity to Estonia. The fund is a full member of the European Private Equity & Venture Capital Association (EVCA) and was basically endowed with 36.8 mil. € ("Arengufond"). Therefore, the state-owned shares in AS Eesti Telecom, equivalent to at least 3 percent participation, were transferred to the fund from its start as the backbone of its investment capital. Investments are alway made jointly with co-investors in order to avoid crowding out effects. The fund contains a team of 15 experts, a supervisory council (9 members) and an international expert commitee (7 experts). Furthermore, the first attempts to establish a formal network of business angels was supported in 2009 (see www.arengufond.ee)

[21] This programme was launched in order to concentrate the R&D and innovation priorities of the Estonian energy sector, to determine the directions of Estonian energy education available, to improve the efficiency and transparency of financial resources, which already have been allocated in the field of energy, to improve inter-ministry cooperation in the field of energy, and to improve cooperation between the state and the energy sector, and within the energy sector.

Figure 2: Innovation Policy in Estonia



Source: Survey "Financing of Estonian innovation system" (Zernike Group 2004, p. 82)

In sum, it can be concluded that Estonia has made considerable effort in order to establish a framework of innovation policy. What we would like to do in this paragraph is to assess these initiatives critically from a Schumpeterian standpoint of evolutionary economics. As the literature overview has shown, the aforementioned innovation policies were only marginally successful. Recently established programmes might be an exception due to some learning effects, but taken as a whole there have been no satisfactory results.[22] However, it has to be stressed that Estonia has had until the present the status of a moderate innovator (see above[23]), and it seems not to be fair to evaluate an innovation policy after ten years when it generally could take a long period (maybe decades in case of Kondratieff dynamics) to recognize the unfolding long-term impact of innovation programmes. Nevertheless, we are going to judge the Estonian activity by some reflections with regard to Schumpeterian theories and policy practices. Hence, the following section is not dedicated to trivialize the aforementioned Estonian efforts, but to provide a more detailed evaluation by differentiating four interrelated aspects:

1. Inappropriate techniques and the addressing of innovation programmes;
2. Strong relationship to an "input-logic" driven growth theory;
3. Programmes are strongly involved within a free trade paradigm allowing an influx of FDIs in low value-added industries and thereby hindering the raise of dynamic comparative advantages;
4. Programmes can be seen as a camouflage, hiding a lack of entrepreneurial culture within the institutional sphere of political administration.

Ad 1) One can state that some of the Estonian initiatives have been viewed critically because of technical aspects (Zernike Group, 2004): Payments are mainly spent retrospectively, thus entrepreneurs still need to raise money for early stage investments to take part in subsidy programmes. In case of applied research grants and feasibility study grants, they are used in tier 3 instead of tier 1 and 2. Thus, an entrepreneur needs to have 50% of the capital by himself. Furthermore, the applied research grants and KredEx guaranteed loans are usually paid in cooperation with banks As Smallbone and Venesaar (2003) have shown, only a very small number of firms benefit from or are even aware of these

[22] As mentioned above, the Total Entrepreneurial Activity Index is still low. Within the Estonian economy, medium and high-tech innovations play only a minor role within the entrepreneurial scenery. Using comparative data from the Eurostat database, Varblane, Mets and Adrijevskaja (2010, p. 14) state: "The share of firms from the high or medium-high technology branches of industry composed 13% of all firms in Estonia. (...) Only two other Baltic countries – Latvia and Lithuania had also very low level of this type of firms."

[23] Schumpeter gave a broad concept of innovation containing five cases (see article above). Christensen (2000) gives theoretically based insights that incremental innovations can lead into a situation of an Innovator's Dilemma. In the case of Estonia, Kattel (2009) has shown illustratively that statistics on Estonia's rise during the 2000s are input- and growth related, while innovation-based development effects are hidden.

programmes. From the beginning, the reform of the Estonian research and innovation system have been carried out seperately by different ministries. Hence, the system was split into two independent parts (academic science and applied science), while the links and interactions between research and industry remained underdeveloped (Kristapsons, Martinson and Dagyte 2003, p. 153). Varblane, Mets and Andrijevskaja (2010, p. 41) clearly pointed out that these programmes have not been aimed thouroughly for Estonian economy's needs:

> "Among other Enterprise Estonia instruments it is possible also for high-tech companies to apply for a 45-75% refund of company's R&D expenditures or applied research costs. Unfortunately up to now the support of growing knowledge intensive firms in the fields of biotechnology [6th Kondratieff?] or information technology [5th Kondratieff!] is very low on the stage of applied research and product development".

Furthermore, the evaluation of aforementioned activities have shown that persons involved in funding procedures "often do not have the necessary expertise, and there is a lack of clarity of assessment criteria, institutions involved are highly fragmented and conduct overlapping projects. Overall amounts of RTDI financing in Estonia is not sufficient to develop a knowledge-based economy" (Varblane/Mets/Adrijevskaja 2010, p. 27).[24] Moreover, Reid and Walendowski (2006, pp. 12) have figured out that the Knowledge Based Estonian strategy contained a number of weak points and missing links:

1. Despite identification of key areas, mechanisms for the selection of R&D institutions were not clearly identified and the responsibilty for pushing forward analysis on the key technology fields was too ambigous;
2. While the strategy clearly argued for the need to ensure support to the new and additional demands for R&D and innovations not only in high technology sectors but also in traditional manufacturing sectors, the measures tend to focus on a small group of higher technology companies and there were no explicit sectoral actions foreseen;
3. The principle focus of most human capital and R&D measures was the investment in infrastructure or specific projects. The underlying assumption has been that this infrastructure will attract young people to become scientists and favour returns of scientists who have emigrated. Other factors such as national and international labour market dynamics for skilled scientists and engineers should also have been addressed.

Furthermore, the innovation programmes SPINNO, R&D Financing and Competence Centres have been criticized several times regarding outcomes and direct innovation effects. However, we have to relativize these technical aspects from a Schumpeterian standpoint, since by moving from 'no-policy policy' to a 'technical unconvinceable policy' something "entrepreneurially" has happened. Albeit there has not been much success in terms of "ideal" outcomes (rates of patenting, returns of licensing, amount of spin-offs created), some "intermediate" outcomes have been observed, i.e. increasing the knowledge about commercialisation and technology transfer in research institutes, creation of basic legislation, procedures and technology transfer organisations (Karo 2010, p. 188; Kalvert/Jürgensson 2009, p. 17; Brighton/Kells 2007, p. 9). Furthermore, the fact that the Parliament discussed and passed the strategy was "itself a significant step forward towards recognition of the role of R&D and innovation for economic and social development of the country" (Kristapsons, Martinson and Dagyte 2003, p. 153).

Ad 2) Generally, Estonia's expenditure to higher education is too low (about 60% of the average level of the EU). Hence, the present situation in training of highly qualified specialists is not sufficient; backwardness in training specialists with doctoral degree is one of the main problems (Kirch 2010, pp. 277). This is, of course, an important problem of pure input logic. From a Schumpeterian viewpoint, the question has to be raised "whether a knowledge investment target [= input logic] has a real economic significance if the local economy fails to appropriate this knowledge (...). It requires capacities within industry to integrate and exploit it, not to mention local finance for the

[24] In this context, Kattel (2004, p. 413) refers to studies that give proof that "in principle, one and the same or similar projects receive financing from several different sources". These technical aspects have been also figured out by an earlier study of Nedeva and Georghiou (2003).

product development phase [development and evolutionary logic]" (Reid/Walendowski 2006, p. 14). In other words, the overall objective of increasing R&D expenditures to 1.5% by 2006 (and 3% by 2013) has some intrinsic weaknesses (ibid, pp. 13):

In this context, it can be stated that the Estonian research funding systems have a tendency for a historical lock-in of funding favouring existing rather than emerging research poles. The implicit assumption of a rapid raise of private expenditures on R&D by enterprises (both in relative share of total R&D expenditure and in absolute terms) is doubtful, since this project increase does not take sufficient account of Estonia's industry structure and its general market orientation. "Firms aren't interested in increasing R&D expenditures just for the sake of it but because they expect that the new or improved production processes, technology concepts, or new products responding to market needs emerging from these activities, will improve their efficiency and hence their long term competiveness" (Reid/Walendowski 2006, p. 13).[25]

Moreover, the strong orientation at the Finish R&D policy system is neglecting the fact that once Finland established its policy and their successful development decisions on so-called weak signals for Schumpeterian processes. An imitation of this modus operandi under different circumstances is endangered with a misleading policy approach and a waste of resources. Kattel (2004, pp. 414-415) has argued in this context that two essential mistakes were made in the policy transfer.

> "For one thing, Finland has implemented very aggressive R&D policies since the 1960s, where the public sector played an important role, which created essential preconditions for the genesis of relatively strong R&D which are aware of the needs of the economy. Secondly, Finland's current innovation policy programmes are based on social and economic signals, which refer to the existence of a firmly organised civil society, science and industry. Neither Estonia's science, society nor economy meets these preconditions today. It would be unreasonable to add more measures stimulating competition to the underfinanced and fragmented R&D system, while competition is basically missing and the interests of entrepreneurship lie elsewhere" (References and footnotes left out)

However, while reading Estonian innovation programmes one sometimes get the impression that Schumpeter's innovation perspective has been seen from an input logic perspective, like the way in that New Growth Theory has interpreted Schumpeter's approach.[26] The policy is more focused on the role of production factors of an innovation-related production function than on entrepreneurial aspects causing the raise of inputs. Thereby, a linear automatism is presumed, which is contradictory to the evolutionary interpretation of Schumpeter's framework (development and evolutionary logic).[27] "Unfortunately learning is not an automatic process, but certain motivation to enter the learning cycle must exist" (Varblane/Mets/Adrijevskaja 2010, p. 22). An input logic approach neglects the process of entrepreneurial learning to reflect and applicate R&D knowledge, normally appearing as tacit knowledge. "Consequently the success of Estonian economy depends heavily on the capability and willingness of firms to adapt and utilise knowledge produced outside Estonia. We need to have skills – to understand the knowledge, be able to use it and to adapt it for creating new knowledge" (ibid). A main task will be to improve the human capital base *and* to skill it

[25] See also the comments of Varblane, Mets and Andrijevskaja (2010, p. 40): "Recent innovation surveys indicated that only a small fraction of Estonian firms innovate and most of those do so by importing capital equipment rather than by conducting basic research themselves or purchasing research services from Estonian or foreign research institutions. It reflects that Estonian firms are often not on the current technology frontier and the growth of their productivity and competiveness does not require the implementation of cutting edge R&D." In the same way, Kattel claimed in 2004 (p. 414) that "to entrepreneurs almost no measures have been channelled in Estonia that would motivate them to invest in R&D projects."

[26] Some of these growth models are more or less innovation-oriented (Romer Aghion and Howitt are well known authors in this realm) in order to overcome Solow's well known black-box "residual." Nevertheless, the common ground of these models is the analysis of an input-stimulated growth path under specific production-technological circumstances (cp. Röpke 2006). For the theoretical reference to Schumpeterian Theory see above, figure 1.

[27] In a similar way, Reid and Walendowski (2006, p. 14) argue: "This aspect of the innovation systems remains relatively ignored by a strategy that remains essentially linear in approach (the hypothesis that increasing research funding in Estonia will automatically lead to increased growth and competiveness in the countries)."

entrepreneurially in order to remain benefits from human capital's and R&D's spillover effects in Estonia. However, the followed path of strengthening academic entrepreneurship within the acdemic scenery still seems to be ineffective.[28]

Ad 3) Estonia still follows a free trade approach in order to attract further foreign capital. One can assume that FDIs by themselves are not directly connected with strong backward and forward linkages (in terms of Hirschman). This might lead to a process of fostering short-term asset booms and triggering "Ponzi schemes waiting to happen" (Kattel 2010, p. 3). "As foreign capital has tended to finance consumption instead of productive investments and has not generated positive returns or export surplus, Estonia faces problems in servicing debt and interest payments" (COST Action 2011, p. 5). Thus, the easy credit boom in the 2000s only "covered up deeper structural problems created through industrial restructuring in 1990s" (ibid, p.9).[29] Varblane, Mets, and Andrijevskaja (2010, p. 8) state that "the inflow of foreign capital is currently still oriented toward reaping benefits from the relatively low labour costs." Taking Ricardo's theorem of comparative advantages into consideration, it can be claimed that Estonia is following a path of specialization on low value added activities by free trade.[30] Consequently, it gets more difficult to emancipate from such a market-driven specialization pressure, and one has to rely on static comparative advantages and to trace a short-term strategy. In terms of modern evolutionary economics, only lower forms of entrepreneurial functions like routine or arbitrage entrepreneurship (see Röpke 2002) have to be curtailed in order to prepare the soil for Schumpeterian entrepreneurship. Varblane, Mets, and Andrijevskaja refer to Havas' analysis of Hungary in order to explain the Estonian situation:

> "economic development can be maintained, or even accelerated, without indigenous R&D and innovation efforts in the short run thanks to foreign direct investment. Country opting for this 'development' path becomes not only overly dependent on foreign technologies, but would most likely to lose its attractiveness, too: at best becoming the 'dumping site' of outdated technologies, or even abandoned by foreign manufacturing firms altogether" (cited in Varblane/Mets/Andrijevskaja 2010, p. 8).

We already described this situation by differentiating between a process of economic growth ("input logic") and a process of economic development ("development logic").[31] Furthermore, if one takes into account some evolutionary variables of action (property rights, competencies and motivation), the dilemma of entrepreneurship in Estonia gets more visible. The central question thus is whether entrepreneurial competencies and motivation within the academic and economic sphere in Estonia can be generated under the actual circumstances (blocked learning process of catching up, free trade paradigm). From this perspective, the role of property rights in terms of tariff and non-tariff barriers have to be reconsidered, at least if one wants to create an atmosphere where dynamic comparative advantages can be achieved. McClelland's "achievement theory" and its implications – task difficulty perceived as too high for Schumpeterian entrepreneurs thereby blocking the rise of entrepreneurial competencies necessary for innovative areas –

[28] Varblane, Mets, and Adrijevskaja (2010, p. 27) have noted: "Even though the two mentioned universities [Tartu University and Tallinn University of Technology] are relatively strong in basic research their commercialization competencies are not yet fully developed, and their training for entrepreneurship is insufficiently integrated in study curriculum".

[29] By 2008, 15 out of 17 banks were foreign-owned with an asset share of 98.2%. Hence, "the Estonian economy was turned into a bubble economy, where foreign capital was directed into services, financial intermediation, real estate, and other businesses that by targeting domestic markets with non-tradable goods do not generate foreign currency earnings, but induce inflationary speculative-led growth" (COST Action 2011, p. 2).

[30] See Reid and Walendowski (2006, p. 32): "[T]he economy remains dominated by labour intensive sectors of production, which are already losing competiveness (textile, furniture). Low value added intermediate products dominate Estonian exports unlikely to create sustained longer term growth due to the relatively low importance of medium and high-technology sectors (both manufacturing and services), this is evident in terms of employment figures."

[31] Statistics generally are not able to detect the development logic effects (and problems) behind input-related growth processes (see above, figure 1). In case of Estonia, Kattel clearly states: "The underlying cause why so many policy analysts and economists missed what is going on in these activities [FDIs] is hidden in the very nature of modularity in production. What are statistically captured as high technology products may in reality be very different in nature: it can be touchscreens for iPhones or it can be assembled mobile phones for any brand mobile producer. Both show up as high technology statistics, yet the former is a product at the beginning of its life cycle and the latter has clearly reached maturity. (...) Thus, even if high technology exports have been growing in developing countries, this does not mean that we deal with similarly dynamic sectors with significant increasing returns and forward and backward linkages. Not realizing this changing technological nature of production became one of the key fallacies for the Baltic States and their chosen economic policy model" (Kattel 2009, pp. 8-9).

can be mentioned regarding the establishment of an innovation system under free market circumstances; "many knowledge-based small enterprises and spin-offs are unable to achieve a critical mass because of an unfavourable environment; they have a short lifetime and weak business plans, they create little know-how and even fewer products, thus having very little impact on both the development of global technology and innovation in the local economic environment" (Tiits et al 2002, p.45).

In his interesting analysis, Marek Tiits states that "the introduction of proactive foreign investment strategy is one of the most effective means in a small country to rapidly increase the knowledge intensity of the economy. However, the Estonian innovation policy (...) has underestimated the power and role of such proactive strategies." According to this, Tiits claims for "much better focusing of the activities of foreign investment agencies and closer co-ordination of FDI strategies with education, research, employment and other policies" (Tiits 2007, p. 324). Hence, an important issue for a country in and after a catching up process like Estonia is determining "which unique competitive advantages are available and how new ones could be created – in other words, what could be the future international specialization of the given economy" (ibis, p. 333). By implementing a free market policy, it is evident that due to the absence of capital restrictions the main tools that are available for policy makers include traditional macroeconomics or FDI policies. Following an innovation policy by controlling and directing useful and less useful FDIs by tariff and non-tariff barriers resp. techniques[32] requires political and economical "development decisions, and thereby decisions about possible future specialization of an economy depend largely on the existence of a comprehensive shared vision of a country's future. Even though it is clear from economic theory [containing a dynamic perspective] that it is more beneficial to specialize in rapidly growing high productivity industries (...)" (Tiits 2007, p. 333).

In this context, the sophisticated and important analysis „Made by Estonia" by Tiits, Kattel and Kalvet (2006) has shown that after the first phase of catching up by liberalization and start up boom the industry is threatened to get stuck in low-added activity by focusing on static comparative advantages. A long-term innovation strategy has to take this into consideration:

> „(...) Estonian innovation policy does not currently provide any effective mechanisms to influence the factors that hinder productivity growth in wood processing or electronic industry [= static comparative advantage], which have greatest impact on our economic growth and exports. Neither are there any schemes that would specifically support the emergence of new high technology economic sectors [= dynamic comparative advantage]" (Tiits, Kattel and Kalvet 2006, p. 92).

Development theory and policy therefore examine the conditions under which decisions can be made, either through pacing devices or inducement mechanisms (Hirschman 1958, p. 26). To integrate those elements we have to break out of the dominant neoclassical paradigm (factor endowment and input logic) in order to focus on the entrepreneurial process of combining input factors. An increase in export per se is not enough to induce economic growth (or development), since exporting low priced products only contributes enough to secure minimal wages (Tiits et al. 2003, p. 6). Furthermore, economic history reveals several problems related to relying on natural resources under free market pressure (Dutch Disease, Efficient Poverty etc.; see Siemon 2010).

Ad 4) The political response to R&D policy has varied from time to time, depending on the ideological attitude of the government. During the early 1990s, first official statements with regard to the importance of scientific R&D activity remained on paper – 'Big science' could wait (Kristapsons, Martinson and Dagyte 2003, p. 139). Consequently, Estonian expenditures on R&D have hovered around 0.5-0.6% (in terms of GDP). The policy system in general could be characterized by a lack of scientific and entrepreneurial attitude. Hence, in combination with a free market stance and the reluctance of resources, there was no drivetrain to engage in these fields actively. Rather, the scientific community failed to establish contacts and promote a dialogue with policy-makers (ibid, pp. 140-142).

[32] Examples include quantitative restrictions on the allocation of bank portfolios in certain areas and the use of foreign borrowings, ceilings on short-term influxes, limits on loan-to-colleteral value ratios on mortgage lending, adjustable capital adequacy ratios and risk weights, and so on (COST Action 2011, p. 2 and the references given there).

During the first years, the Department of Foreign Trade played a central role in the harmonization of various legal acts and acted as a coordinator of measures to integrate Estonia into the EU and the WTO (Lumiste, Pefferly and Purja 2007, p.17). At this time, there was a so-called 'window of opportunity:' "Soviet Estonia had no Ministry of Foreign Affairs and hence no political history. (...) In the early 1990s the department employed many young people who did not have the burden of associations with the old system." At first glance, this could have been an ideal situation for the implementation of a Schumpeterian innovation policy. As has been shown by historical examples, some states did successfully create novel know-how and innovation (Reinert 2008). Tiits et. al (2003, p. 46) even go further when they postulate that the government is obliged

"to change, reform and readjust institutions and environment (legislation, the educational system, etc.) and to demonstrate innovation in policy making." The well-meant strategy "Knowledge-based Estonia," however, was just a framework; the real implementation needs an entrepreneurial attitude within the political sphere. Kattel (2004) has argued impressively that Estonia's R&D system has been based too much on market-orientated competition and partnerships as a core policy aim, but has lacked the tools to create sustainable state capacity to support technological development. In regard to this, Tiits, Kattel and Kalvet (2006, p. 21) identify a strong misjudgement of policy makers due to the strong input logic interpretation of the innovation process: "Even if Estonia did manage to rapidly increase its investments to the level of 3-4 per cent of GDP, we would still remain but a very modest contestant on the international scale. Yet Estonia's existing research and innovation policy has undertaken to follow the assumption that Estonia is just as big a player as the US or the European Union are." And with regard to FDIs, they claim that 'the right kind' of policy decisions are more effective and cheaper than an input logic approach: "Implementing this strategy, however, requires exceptionally professional and determined public policy development; including enforcement of convergence between the policy of attracting high technology focused foreign direct investments and the existing structure of economy, and a proactive technology transfer policy to ensure that the know-how accompanying the foreign direct investment actually gets passed on to domestic enterprises" (ibid).

Likewise, Drechsler (2004, p. 393) states: "The key economic and development issues of today, sustainability, dynamic markets, innovation and technology, actually foster the role of the state for economic growth (…). The Schumpeterian, innovation-based world cannot be imagined without a capable state actor (…)" (ibid). Therefore, the bearer of development decision within the institutional landscape of innovation policy has to be endowed with entrepreneurial capabilities and motivation, but also provide traditional public goods. According to this, Drechsler pleads for a Weberian-based and Schumpeter-orientated re-interpretation of the New Public Management Approach, a management philosophy used by governments since the 1980s to modernise the public sector[33]:

> "The key to succesful PA [Public Administration] reform, vital as it is not only, but also, for economic growth, as well as, if you will, for good governance, is to strengthen administrative capacity and competence of a responsive and responsible state. The optimal solution for this is a genuine post-post-NPM [New Public Management] system, Weberian-based but with the lessons from NPM learned, which – and this is not less right for being a cliché – puts the human person into the center of administrative decision-making. And this is a Neo-Weberian State, with attention to the specific local reality, and with the final goal, as always, of the Good Life in the Good State" (Drechsler 2005)

Moreover, Karo (2010, p. 174) states that "the emulation of institutions may be a bigger challenge in the catching-up context than the emulation of technologies."[34] According to his institutional thinking, the governance of public science

[33] See www.wikipedia.de: "New public management is a broad and very complex term used to describe the wave of public sector reforms throughout the world since the 1980s. The main hypothesis in the NPM-reform wave is that more market orientation in the public sector will lead to greater cost-efficiency for governments, without having negative side effects on other objectives and considerations."

[34] In this context he refers to political-economic problems of an innovation policy regarding the cyclicity and the self-centred attitudes of politicians in order to be re-elected: "The process of emulation of governance of science and innovations systems is further complicated by the technological cyclicality of economic development (...) and changing cumulative understandings about

has gradually moved from a purely "public good" based rationale to a more "network" based rationale. The relative low success of Estonian innovation policy can then be interpreted "as a general weakness of the science and innovation system to provide basic capabilities and supporting governance structure and capacities for innovation-based economic restructuring" (Karo 2010, p. 185). He argues that the adoption of seemingly "successful blueprints" like the US Bay-Dole Patent and Trademark Act of 1980, granting institutions of public science and also individual scientists the right to claim property rights (patent, copyrights, trademarks) of the scientific knowledge created through public funding, may not be successful without a perspective that contains a more systemic approach providing a historical institutional perspective. "The lessons from the US science and innovations system should not be learned in terms of what policies or what kind of reforms have been carried out, but in terms of what was the combined structural and institutional effect on different aspects of the governance system" (Karo 2010, p. 181). We have already stated that entrepreneurs and scientists complained about a lack of expertise within the sphere of public administration after they applied to attend innovation programmes (see above). Furthermore he states: "Although Estonia has adopted a joint Research and Development and Innovation Strategy, *Knowledge-based Estonia*, it should be only seen as a formal change in policy rhetoric towards a more coordinated policy arena – direct policy measures to coordinate both the design and the implementation of R&D&I logic like National Technology Programmes (which are merely tools of coordination) have not been fully implemented (first two programmes starting in 2009)" (Karo 2010, p. 187, fn. 11).[35]

III. Conclusion: The Free Market Doctrine on Trial

A country that is going to continue its catching-up or leapfrogging development process must have innovative entrepreneurs paving the way for all other kinds of entrepreneurs.[36] These innovators have to be allowed, able, and willing to adapt and transform their resources ('input': knowledge, capital, natural resources, etc.) within their domestic markets in order to induce positive linkages to all sectors of industry.[37] The specific characteristics of the catching-up process of small countries are on the one hand limited resources and growing complexity of developing basic technologies hindering the establishment of a cost-intensive infrastructure. On the other hand, global market for low and medium technology products are increasingly dominated by the scale and cost-advantaged and rapidly industrializing countries, e.g. South East Asia, India, and China (Tiits, Kattel and Kalvert 2006, p. 20). Hence, the main challenge for catching-up economies like Estonia lies in "their capability to be innovative while learning to use and develop the latest imported technologies, simultanously with establishing domestic industry that is competitive on international markets" (ibid, p. 19).

In order to build dynamic comparative advantages by entering a new techno-economic paradigm (based on weak signals: holistic health; bio-/nanotechnology), an effective industrial policy (picking the winners) by investments in BCG-Matrix' „question marks" is needed by overcoming Hayek's information problem ("arrogance of knowledge").[38]

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proper institutional underpinnings of these developments (from a linear to a more systemic understanding of technological change)" (Karo 2010, p. 175).

[35] During recent years a significant shift in the overall financing of and emphasis in the science and innovation policy can be observed. The MEAC was relatively under-represented in funding innovations until the introduction of the EU Structural Funds in Estonia. It funded about 14% of the total state budget for R&D in 2002, while it increased to approximately 40% by 2006. The rest has come through MER (with other ministries playing a minor role funding up to 1.2% of the R&D budget (Karo 2010, p. 187). In this context, the evolution of innovation programmes can be explained: "it is almost easier to initiate new policies than to change structural characteristics or old policies of a particular system. Therefore, it is not surprising that new policy initiatives, such as National Technology Programmes are initiated in Estonia in another attempt to create a horizontal coordinating mechanism into a structurally fragmented system that is not likely to produce the desired solutions" (Karo 2010, p. 194).

[36] For leapfrogging in general, see Brezis, Krugman and Tsiddan (1991). In context with the catching up process in the case of China, see Zhu, Lynch and Jin (2011).

[37] The important role of innovations is neglected in the conventional theory of international trade, since the role of entrepreneurs' efforts "combining given factors in a new way" is ignored theoretically. It reflects an entrepreneurial behaviour Schumpeter described as the actions of a 'mere manager" (or 'routine entrepreneurship' in terms of Jochen Röpke). The endowment of given production factors (labour, capital, knowledge, etc.) is the basis for a production function-oriented explanation for the bulk of international trade fluxes. Heckscher-Ohlin's theorem (and its followers) reigns. Schumpeter's cornerstones of economic development (innovation, entrepreneurship, finance) are difficult to integrate in standards economics – but the other way around might be more fruitful (see Siemon 2010).

[38] The statement of a high innovation policy official – "How should the government know which sector ought to be supported, and why and when" – would be a strong rapprochement to the "drastic market ideology" which has been characteristic of Estonia's policy approach throughout the period after regaining independence in the 1990s (Kattel 2004, p. 414). Hence, Tiits (2007, p. 336) claims

Finnish economic development in the 1970-1980s and the policies implemented to catch up with Sweden are valuable recent examples (Tiits, Kattel and Kalvet 2006, p. 60). Tiits, Kattel and Kalvet (2006, p. 9) state that "without this policy and with the continuation of current specializing trends, Estonia is unlikely to ever catch up with the level of economic development in the European Union, the US, or the 'Asian Tigers.'"

Estonia's export sector products are based on natural resources (wood processing activities) and low value adding functions of Scandinavian information technologies and electronic clusters (endowing cheap/low-skilled labour) being engaged primarily at the end of the product life cycles. Therefore a shift towards new comparative advantages is necessary to vitalize older industry segments and to establish new industry cycles.[39] "Increasing wealth (wages and profits) and employment in Estonia is only possible in the long-term with the sale of innovative products and services to foreign markets. To achieve this, Estona must break out of the stereotypes associated with transitional countries and make itself known in the world as an innovative country" (Reid/Walendowski 2006, p. 32). The Schumpeterian orientated literature on Kondratieff dynamics has shown that for basic innovations in Kondratieff cycles 5 and 6 the role of academic knowledge and entrepreneurship has grown tremendously (Perez, 2002; Reinert, 2008; Röpke, 2006). Therefore, a strategy to break out of the free trade paradigm temporarily has to be accompanied with establishing a culture of academic entrepreneurship by coaching them to strengthen their capabilities and motivation. This culture is – despite certain efforts – still lacking. As long as the Estonian innovation policy will only be directed to producers with cost advantages and low scientific input, there will be no real economic development in the Schumpeterian sense. Thus, the framework of innovation policy in Estonia is like a gilded cage, supporting enterprises, but capturing entrepreneurship.

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for an innovation orientated policy approach containing a political system endowed with entrepreneurial competencies: "Predicting the future dynamics of an industry is a very complicated task. The government **must be** nonetheless aware of main development trends, challenges and the likely reactions of companies in their key industries. Not being informed about the industrial dynamics leads very easly to a significant waste of resources, e.g. in the development of human resources and technological capabilities or in trying to attract FDI to industries where there is no chance of success." For the potential of nano- and biotechnology as driving forces of the next forthcoming paradigm (6th Kondratieff) see Tiits, Kattel and Kalvet (2006, pp.29) or Siemon (2010).

[39] "Estonia should start implementing a more proactive foreign investment strategy paying special attention to attracting ICT, biotechnology and nanotechnology related investments. This should be done with regard to radically new industries (e.g. biotechnology-based pharmaceutical industry, bio- and nano-electronics, etc.) as well as through modernising the traditional areas dominant in the Estonian economy (e.g. usage of IT or biotechnolgy in wood processing, food processing, textile or chemical industry, etc.)" (Tiits 2007, p. 338).

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