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**THE BALTICS AFTER  
„DARK“: WAY TO THE  
EUROPEAN UNION**

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## **Introduction**

The Baltic States set extremely ambitious goals for themselves after the dissolution of the Soviet Union (Kasekamp 2010). The wave of changes following the communist system breakdown was not assumed as a tragedy, rather as a unique opportunity to return to the “normal” way of development. Having experienced the independent statehood in the beginning of the twentieth century, the idea of sovereignty gained a popular support even before the official delegitimization of the Soviet rule. The challenges of the transition were widely accepted simultaneously from public and the governments. Following the path of western type of development, the Baltic States started to modernize the every sphere of economic, political and social lives. It was their major response to the “new era” challenges.

It is assumed that transition process covers the period from 1992 to 2004. It started right after the official recognition of independence and finished with incorporation in the European Union. No any other former soviet republic achieved the same results. The core research question is: **Why was the Baltic States’ transition successful?** The paper will discuss the most vulnerable transitional problems and the solutions exercised in the Baltic States.

## **Chapter I**

### **Conceptual Part**

#### **1.1. The Theory of Modernization**

The theory of modernization experienced a remarkable revival after the collapse of communist regimes. Most of the sociologists defined it as universal and an inevitable process with the same characterizing factors: economic growth, individualization, secularization, rationalization and so on. According to the definition of Robert Brier “In modernization theory, modernity is seen as an internal achievement of national societies which consists primarily in socioeconomic development” (Brier 2009). The dominant approach towards the modernity has been based on the assumption that the universal patterns produced by modernity resemble the experience of Western Europe. This theoretical stream is challenged by Shmuel Eisenstadt - one of the most influential sociologists of 20<sup>th</sup> century. In his essay “Multiple Modernities” he defines modernity

as multi-dimensional rather than as a homogeneous process. Eisenstadt assumes that the modernization process has to be analyzed in a civilizational context. He insists that the cultural dimensions have to be considered as a crucial element of particular modernization processes.

Modernization and Westernization are often times used simultaneously, but this does not hold true in every situation. To take for example China, a highly modernizing country with well-developed technology and a booming economy, one can hardly say that it has much in common with the Western European model of modernization. Alternatively, in terms of secularization we can examine the case of traditional Muslims living in European urban centers, thus in highly modernized environment who only selectively adopt certain aspects of “Western” culture. Despite this, they might consider themselves to be entirely “modern”. (Smith 2006) This is why Eisenstadt’s theoretical assumptions are accurate.

As we observe recent changes within civilizations, this has created the necessity to rethink modernization theories. While talking about modernity we should consider that it is a multidimensional notion and must always be discussed in regards to a specific aspect. Charles Taylor, expanding on Eisenstadt’s theory, writes:

*“Transitions to what we might recognize as modernity, taking place in different civilizations, will produce different results, reflecting their divergent starting points. Their understandings of the person, social relations, states of mind, goods and bads, virtues and vices, sacred and profane, are likely to be distinct. The future of the world will be one in which all societies will undergo change, in institutions and outlook, and for some these changes will be parallel, but it will not converge, because new differences will emerge from the old. Thus, instead of speaking of “modernity” in the singular, we should better speak of “multiple modernities.”*(Taylor, Lee)

The most interesting point in Taylor’s assumption is that modernization processes do not end up with identical results even though they might be based on the same principles such as urbanization, rationalization, mass literacy, democratization, market economy etc. The march of modernization will not lead to homogenous world culture, because it is not just a single wave (Taylor, Lee). Rather, different civilizational cores and collective identities create various

sources of modernity programs and have a constant impact on the socio-economic, political-institutional and technical-scientific dimensions of modern societies (Spohn 2001)

Focusing on the origins of Western European modernity, it is assumed that it was spread out to Eastern Europe, particularly to the Baltic States. So what was it about?

The roots of the Western European modernity can be found in medieval times, particularly during the Enlightenment; it then developed and crystallized through the Great Revolutions. Eisenstadt discusses the three basic values on which European modernity is based: “individual autonomy; the liberation from the traditional constraints of political and cultural authority as well as the growing human cognition; and control and transformation of the natural and social world” (Spohn 2001). Institutional forms of political modernization such as state-building, nation-building and participation of people in politics are based on these values. This type of modernity spread out to Eastern Europe after the collapse of communist regimes. The most interesting aspect of Eisenstadt’s theory is that the process of Western European modernity was diffused rather than “copied” and implemented in its original terms.

*“Not only do multiple modernities continue to emerge – by now going beyond the premises of the nation-state – but within all societies, new questionings and reinterpretations of different dimensions of modernity are emerging. The undeniable trend at the end of the twentieth century is the growing diversification of the understanding of modernity, of the basic cultural agendas of different modern societies – far beyond the homogenic and hegemonic visions of modernity prevalent in the 1950s. Moreover, in all societies these attempts at interpreting modernity are continually changing under the impact of changing historical forces, giving rise to new movements that will come, in time, to reinterpret yet again the meaning of modernity” (Eisenstadt, 2000, pp. 23-24).*

The next section will analyze the “Baltic way” of modernity.

## **1.2. Modernization in the Baltic States**

Keeping in mind the heterogenous nature of modernity, the particular attention will be paid to the characteristics of modernization process in the Baltic States. It can be assumed that transition

and modernization were the same processes in the Baltic States. The achievement of the main transition goal – return to Europe was not possible without modernization, thus the two notions can be used interchangeably.

The Baltic States were excluded from European “family” during the five decades. Soviet invasion in early 1940s blocked their way to “normal” European type of development. The fall of iron curtain opened the window of opportunity to return to the “promised land” – Europe. To use the terminology of Jürgen Habermas, the revolution of 1989 was “rectifying revolution” (Habermas, 1990). The metaphor of “normalcy” was often used to express the belief in the “return to Europe” (Lauristin, 2007).

The “return to Europe” was most explicitly expressed in institutional integration into European and international structures. After the first euphoria of achieving independence, the Baltic countries started striving for the end-goal – European Union, North Atlantic Treaty Organization (NATO), the Organization for Security and Cooperation in Europe (OSCE), the Council of Europe, the World Trade Organization (WTO) and so on. In order to distance themselves from the long-time Soviet legacy, the Baltic States had to build everything from the scratch that obviously would not be easy. Challenges of transition were welcomed though. The first considerable result was the admission of Latvia and Estonia into the Council of Europe in 1993. At the same time they started cooperation with OSCE, establishing its mission for the purpose of dealing with Russian minorities in Latvia and Estonia. In 1994 Baltic States expressed their willingness to join NATO by joining NATO’s partnership for peace program. Soon after, in 1995 three of the Baltic countries formally applied for the EU membership.

Important aspect of western integration is that it has never been the “one-way-street”. If there were not the mutual interests between so called “new democracies” and “old Europe” most likely the integration would not be successful. The role of external and internal factors in this process has to be paid particular attention. According to Marju Lauristin, “when speaking of “external factors” we mean those influences, emanating from the presence of international, intersocietal and intercultural forces in a given society, whereas “internal factors” refer to the mutual interrelations of values and social structure (social class, ethnic groups, generations, gender groups etc) as they are institutionalized in a given society” (Lauristin, Vihalemm, 2009). Concerning the role of internal and external factors in modernization process, two radical

approaches dominate in academic circles. Some scholars assume that without an influence and support of international institutions the outcomes of transition would not be sufficiently good and the countries would end up in “grey zone”.<sup>1</sup> Swedish economist Anders Aslund assumes: “The EU provided a ready-made model of working capitalist states and it assured these countries [of Central and Eastern Europe] would not fall off the map” (Aslund, 2007). Even though Aslund’s assessment could be slightly exaggerated, the positive outcomes of foreign input cannot be neglected.

Cooperation with Nordic neighbors was a great help for Baltic States in modernization process. Scandinavian countries were interested in having stable and successful neighbors in the region. For this purpose they provided newly independent countries not only with technical support but also encouraged intensive regional interactions at the grass-roots level: “churches, schools, professional associations, sport clubs, cultural societies and various other components of civil society eagerly established a dense network of people-to-people contacts across the Baltic Sea” (Kasekamp 2010). These ties were especially tight between Estonia and Finland because of linguistic proximity. In terms of institutional cooperation, in 1990 the Nordic-Baltic Cooperation (NB8) was established in the format of 5+3, including 5 Scandinavian (Finland, Denmark, Norway, Sweden, Iceland) and 3 Baltic (Latvia, Lithuania, Estonia) countries. Later on (1992) Council of Baltic Sea States (CBSS) was established with 11 member states.<sup>2</sup> The influences of Nordic countries led the Baltic States’ modernization process to significantly positive outcomes. As Kasekamp claims, “the Nordic countries were the most significant investors in the region and supported the interests of the Baltic States in international organizations” (Kasekamp, 2010).

On the other extreme, some scholars are skeptical towards external agencies, assuming that “exported” transition agendas fueled the social inequalities. Lauristin offers milder view, claiming that the Baltic transition should be considered in the context of interactions between external and internal factors (Lauristin, Vihalemm, 2009). The main logic behind this assumption is that internal and external factors are often times fused which makes difficult to make clear dividing line between them. “Exported” concepts of transition agendas such as “marketization”,

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<sup>1</sup> The term is used as a metaphor for hybrid regime, resulted by unsuccessful transition

<sup>2</sup> Today it has 12 members : Denmark, Estonia, Finland, Germany, Latvia, Lithuania, Norway, Poland, Russia, Sweden, European Commission, Iceland (joined in 1995).

“liberalization”, “state and nation building”, “social justice”, “sustainable development” have not been produced in vacuum, “but have mostly been a product of “discursive learning” in the process of interaction between domestic elites and their international partners. Some of these concepts are prioritized and privileged in the political agenda and/or in popular beliefs, others are not; some of them were widely supported during the transition years and became contested only recently; some of them were pushed to the margins or even completely neglected” (Lauristin, Vihalemm, 2009 ). Even though some radical modernist approaches insist that post-communist countries simply “imported” and “copied” western modernization elements, one should also consider the historical legacy (civilizational context) as an important determinant of successful transition.

As we observe transition in the Baltic States showed the pattern of Western European type of modernization. It was expressed both in terms of institutional integration and implementation of the Western European values. But as it was mentioned above, Western European modernity is far from uniformity and directedness. Rather, it is transformed within the specific cultural context. Historical and cultural memories of Baltic countries in some point determined their political choices and encouraged the specific mode of Western European modernity. Also the new level of Baltic-Scandinavian relations caused by geographical and cultural proximity added the extra specificity to Baltic modernity.

## **Chapter II**

### **Economic Transition**

#### **2.1. Shock Therapy vs. Gradualism**

With the end of communism the series of fundamental changes has started in Central and Eastern Europe. New economic system had to be built from the scratch. Because of the five-decades-long co-existence within the same system, the Baltic States’ economy was tightly connected to the Soviet economy. Soviet empire collapsed, ties broke down, only chaos left from the ruins of previous regime.

In the Baltic States there was wide consensus over the final destination - building capitalism. But how it had to be done? Was it possible to “make aquarium out of the fish soup”? What strategy of transition would be the most efficient, rational and effective? How fast and in what order the

reforms had to be carried on? The discussions were going around these questions. The intellectual circles divided into two groups: radicals and gradual reformers. Accordingly, discussions heated around the two dominant streams of transformation strategy: “shock therapy” – supported by the former and “gradualism”- encouraged by the latter.

Shock therapy followed the principles of so called “Washington Consensus” – the neoliberal economic agenda offered by American economists<sup>3</sup> and international financial institutions: the World Bank (WB) and International Monetary Fund (IMF). “Washington Consensus” was originally created for Latin American countries in the second half of 1989. It codified a set of fundamental policy-instruments that were desired to implement in order to emerge from debt crisis. The main principles of the Washington Consensus were: privatization, trade liberalization, competitive exchange rate, fiscal discipline etc.<sup>4</sup>

These ideas were widely accepted and further developed by many radical economists in Central and Eastern Europe. But it has to be mentioned that reform program in post communist countries was not “copied” from Washington consensus. Main principles remained the same but many issues were changed. As Anders Aslund assumes, the Balcerowicz’s program, “the first truly market economic program [which] became the standard for the radical, comprehensive reform” in post-communist countries, was created separately from Washington consensus. It emerged within the circles of Polish liberals in the late 1980s (Aslund, 2007). Shortly describing the fundamental structure of post-communist economic reform program, we should emphasize three main pillars which it was based on: **privatization**, **liberalization** and **macroeconomic stability**. Privatization process meant the denationalization of state property. All the medium and small size interposes had to be transferred into individual ownership from the very beginning of transformation, later on the large-scale companies had to share the same fate. The extent of privatization was measured by the share of private sector in GDP. The desirable score was chosen as 60 per cent of GDP. The logic behind the privatization was that private industry was more efficiently managed (based on competition) than state enterprises.

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<sup>3</sup> The term – “Washington Consensus” was originally used by John Williamson

<sup>4</sup> See: John G. Williamson, “Lowest common Denominator or Neoliberal Manifesto? In *Challenging the Orthodoxies*, 13-23. London: Macmillan, 1996.

<http://www.google.com/books?hl=cs&lr=&id=8gFjw1ZWLRUC&oi=fnd&pg=PA13&dq=John+Williamson+washington+consensus&ots=LtnKfHWODB&sig=aqk6Vz0omn3dzD7bUeZJYobEiSk#v=onepage&q=John%20Williamson%20was+hington%20consensus&f=false>

Liberalization was about price deregulation, reduction of the trade barriers to the minimum level, creation of necessary conditions for the intensive inflow of foreign direct investments, elimination of monopoly. It was believed that swift and full-scale liberalization would restrict corruption and the rent seeking practices.

Macroeconomic stability was mostly concentrated on effective fiscal and monetary policy in purpose of avoiding budget deficits and inflation. Maximum level of inflation was chosen as 40 per cent.

The essence of shock therapy was the speed and quality of reforms. It was widely believed that everything had to be done in a very short time-period and everything had to be changed fundamentally. Radical reformers assumed that the quick dynamics largely determined the success of the whole process. As Anders Aslund assumes, “slow privatization might never take off... [and] partial liberalization leads to a very corrupt system of excessive state intervention aiming at extortion”(Aslund, 2002).

The supporters of shock therapy argue with the assumptions of social psychology. They claim that severity and sharpness of comprehensive reforms make society more resistant. People are aware of considerable amount of “pain” but the hope for the future gains makes them go for short-term sacrifices. Also, as Balcerowicz writes, “people are more likely to change their attitudes and their behavior if they are faced with radical changes in their environment, which they consider irreversible, than if those changes are only gradual” (Balcerowicz, 1995).

Even though the radical reformers support the swiftness of the reforms they take into account the fact that “different processes of economic reform have different maximum possible speeds” (Aslund, 2007). But they agree on one important point: the first jump has to be very big (ibid). So the formula of shock therapy was: liberalization on the first stage, and restructuring – on the second. Alternatively, gradualists supported the following strategy: step by step implementation of institutional reforms on the initial level – and introduction of market economy - later on. This approach was widely supported by the American economist, Nobel laureate – Douglass C. North. His analysis of economic change is based on institutional approach. North believes that economic performance is depended on formal and informal institutions, norms and rules. He claims that the revolutionary change of formal rules will not bring the desirable results because it could not be followed by the same changes in informal norms.

*“While the rules may be changed overnight, the informal norms usually change only gradually. Since it is the norms that provide "legitimacy" to a set of rules, revolutionary change is never as revolutionary as its supporters desire and performance will be different than anticipated. And economies that adopt the formal rules of another economy will have very different performance characteristics than the first economy because of different informal norms and enforcement. The implication is that transferring the formal political and economic rules of successful western market economies to Third World and eastern European economies is not a sufficient condition for good economic performance. Privatization is not a panacea for solving poor economic performance” (North, 1993).*

Another supportive argument for gradual reforms was developed by political economists (Adam Przeworski, Gerard Ronal, Mathias Dewatripont, Phillipe Aghion). They stress on the political costs of radical reforms by saying that the economic shock will undermine the popular support for democracy (Aslund, 2007). According to their assumption, the social costs of shock therapy are devastating while the gradual reform does not necessarily cause the vulnerable social problems.

Even though the final goal of gradualism and shock therapy programs were the same (market-based capitalism) the former strategy still retained socialist views. The essence of gradualism was the maintenance of state intervention allowing the “divide and rule” tactics and entitling the government to agenda-setting power.

Gradualists were taking the Chinese reform as a role model. In 1993 China officially proclaimed the changeover of economic system from planned to socialist market economy. Chinese reforms were gradual, based on experiments and controlled by old communist Nomenclature. There was no need of shock therapy in China because the system did not go through the devastating turbulences as it happened in post-Soviet area. Also, some experiments, undertaken by China, had already been exercised in the Soviet Union when Gorbachev introduced so called “perestroika” program. Partial liberalization and slight abandonment of the prices fueled rent seeking practices by the members of Soviet Nomenclature. Tackling down the hyperinflation turned out to be impossible in the Soviet Union, while Chinese government never lost control

over macroeconomic stability (Aslund, 2007). China was reformable, it had enough resources to establish a new economic order on the basis of the old system. The specificity of Chinese reform strategy was its dual character. Along with the introduction of neoliberal economic policies, China promoted the strategy of big industries. “This quest to establish large-scale conglomerates, in effect a policy of developing national champions, looked more towards...Asian model of capitalism and to the practicing of close collaboration between the state and large corporations, as seen in the *Chaebol* of Korea and the *Keiretsu* of Japan” (Wilson, 2007). On the contrary of Chinese case, nothing helped the Soviet Union to survive. Post-Soviet countries did not feel any ground under the feet, there was nothing to reform.

As we observe very little can be compared between China and post-communist countries. Gradualist theory has acceptable logic, but I would assume that shock therapy was better choice for post-communist countries only in case of matured political will, good strategy and full mobilization.

Post-communist countries followed the different paths of transformation. Some of them ended up in utter failure, others managed to overcome the painful transformation relatively better. The Baltic States were one of the leading transformers who chose the strategy of shock therapy from the very beginning of independence period. Next section focuses on the certain aspects of economic transition in Estonia, Latvia and Lithuania.

## **2.2. Shock Therapy in the Baltic States: How Did They Perform?**

The outcomes of the shock therapy were expressed in dynamics of GDP, the private sector share, inflow of foreign direct investments, inflation and corruption level. These topics will be discussed on the following pages.

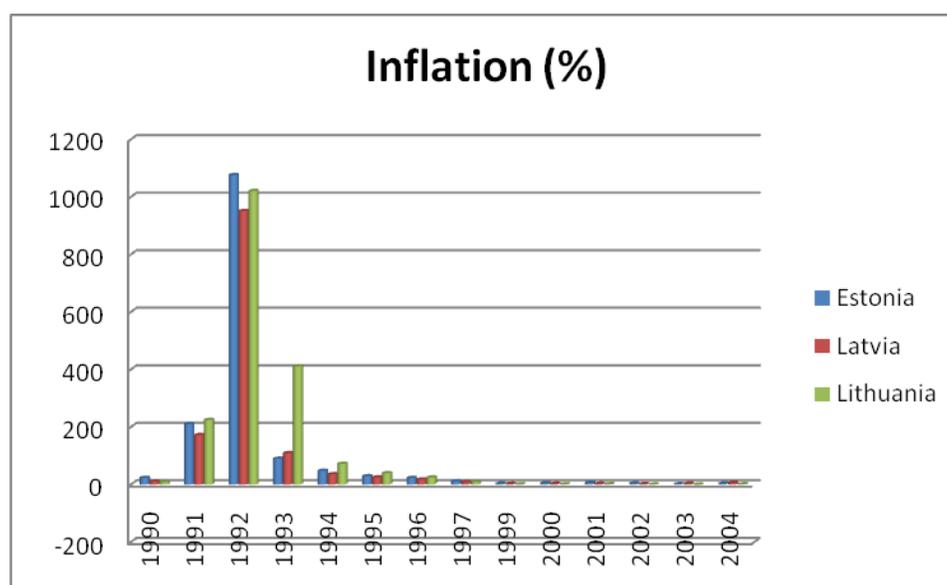
Estonia was the first country which sobered immediately after the first euphoria of the soviet system breakdown. It launched the reforms from August 1991 when the Soviet Union recognized the independence of the Baltic States. Estonia’s courageous steps were big stimulus for the other “Baltic Sisters”.

Estonia was the first post-Soviet country which introduced own currency-crone (*kroon*) and left ruble-zone in 1992. Kroon was fully convertible to the German Mark at a fixed rate of 1DEM=8EEK.

Latvia and Lithuania took a bit longer path. They introduced temporary currencies parallel to the Russian *ruble*.

Lithuanian *talonas* were issued in 1991 and in Latvian *rubelis* was introduced in 1992. Later on they followed the path of Estonia and introduced their own currencies – Lithuanian *litas* and Latvian *lats* in 1993.<sup>5</sup> Currency reforms were aimed to control booming inflation. In 1992 Estonian inflation indicator reached 1076%; the same indicator showed 951.2% and 1020% in Latvia and Lithuania respectively. After the introduction of internal convertibility of the *ruble*, inflation indicator dropped sharply and during the next two years it went below the critical level (40%) in all the Baltic countries (Chart 2.1).

Chart 2.1



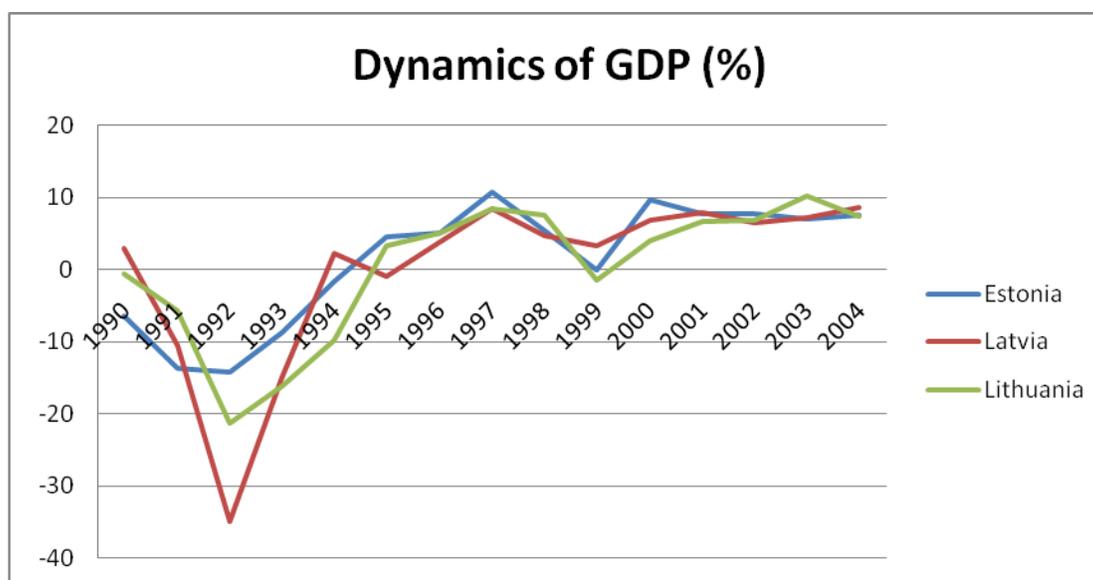
	1990	1991	1992	1993	1994	1995	1996	1997	1999	2002	2003	2004
Estonia	23.1	211	1076	89.9	47.7	29	23.1	11.2	3.3	3.6	1.3	3
Latvia	10.5	172	951	109	35.9	25	17.6	8.4	2.4	1.9	2.9	6.2
Lithuania	8.4	224.7	1021	410	72.1	39.6	24.6	8.9	0.8	0.3	-1.2	1.2

Source: EBRD Transition Report 2002, 2008

<sup>5</sup> Baltic States had their own currencies during the interwar period. Estonian *kroon* was circulating from 1928 to 1940, first pegged to Swedish krona with gold standard, later it was pegged to British Pound. Latvian *rubelis* was introduced in 1919 and replaced by national currency lats in 1922. Lithuanian litas appeared in 1922 and existed until 1941.

High inflation rate causes the fall of output which, on its side, creates obstacles for economic growth. Analyzing the correlation between macroeconomic stabilization and economic growth, Anders Aslund writes: “The fall in output outlasted high inflation in every single [transition] country, and no country returned to economic growth until inflation had fallen below 45% a year. The longer high inflation lasted, the greater the total contraction of output” (Aslund, 2007). If we observe the dynamics of the Baltic States’ GDP in transition years, strong positive correlation between inflation and economic growth will be revealed (Chart 2.2). The biggest drop of GDP is observed in 1992 when the Baltic States established new currencies and experienced monetary turbulences. Another drop of GDP is observable in 1998 and 1999 as a result of Russian financial crisis. Weak enterprise sector and banking system caused fiscal problems and set the stage for vulnerability to change in investment sentiment in Russia. (EBRD Transition Report, 1998). The Baltic States were hit by the crisis because the companies exporting products on Russian market went bankrupt. The Baltic States managed to recover soon. It is reflected on upwards slope of GDP indicator in 2002. As Kasekamp assumes, these economic setbacks had “the salutary effect of weakening Baltic companies from the eastern market and forcing them to reorient to the European Union” (Kasekamp, 2010).

Chart 2.2



	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2003
Estonia	-13.6	-14.2	-8.8	-1.6	4.5	5	10.8	5.4	-0.1	9.6	7.7	7.1
Latvia	-10.4	-34.9	-	2.2	-0.9	3.9	8.4	4.7	3.3	6.9	8	7.2
Lithuania	-5.7	-21.3	-	-9.8	3.3	5.1	8.5	7.5	-1.5	4.1	6.6	10.3

Source: EBRD database

Macroeconomic stabilization is not the only determining factor for economic growth. The extent of privatization has to be taken into account.

Soviet industrial networks broke down along with the system-collapse but the creation of new networks took some time. It was quite difficult to establish new, viable enterprises out of soviet-time combines (*combinat*). The Baltic States followed the neoliberal strategy – privatization first, restructuring- afterwards. They adopted the laws on ownership and transferred enterprises to private hands. The next level –establishment of new private enterprises from the scratch (“construction” process) was a matter of particular industrial policies.

Estonia chose a very ambitious privatization strategy. With adopting the Privatization Act and establishing the Estonian Privatization Agency (EPA) in 1993, the legal and institutional framework has been shaped.

Estonian government made an explicit commitment to sell all the state assets as quickly as possible. On initial level, there were 10 000 small and 500 medium and large size enterprises to be privatized. The small enterprise privatization was simple and quick. They were sold by auction method to the highest bidder for cash. The process finished in two years.

But the privatization of large and medium size enterprises took a bit late start. The process was socially and politically costly; initial procedures were complicated. Estonian parliament had an authority to approve the sale of so called strategic enterprises such as: airports, energy, railway and telecommunication companies. By the year of 1992, only seven of medium/large size enterprises were sold. But privatization process speeded up from 1994 and in three years almost all (472) medium/large enterprises were privatized. (See Publications of Estonian Institute, <http://old.estinst.ee/>).

Privatization methods widely defined the success of the whole process in Estonia. Majority of sales were done by tender method. As a result, most of the units were bought by outside

investors who tended to bring the modern management and marketing skills. Selling the enterprises to foreign investors had two-fold impact: it helped the privatized companies not to bankrupt and increased the inflow of foreign investments. According to Database for Business and Public Administration, the investment in fixed assets increased from 4401 million EEK in 1993 to 19529 million EEK by 1998 ([www.balticdata.info](http://www.balticdata.info)).

Considerable amount of sales were done by auction method. There were no employment guarantees required by this method. Also there was no requirement of continuation of previous production as well. This is the reason why this method was quite handy and widely exercised in Estonia.

The share of voucher privatization was quite moderate in Estonia. Vouchers were issued for the people to compensate their property prior to 1940 (restitution vouchers) or based on the employment time in Soviet Republic of Estonia (national capital voucher). People could use vouchers to buy land, housing, bonds from Compensation Fund or exchange them for the share in companies or investment funds. The main problem with vouchers was their value. After the full liberalization of vouchers in 1994, their value was about 37% of its nominal value. From 1995 the government announces an “extra way” of using vouchers people could use up to 50 per cent of voucher’s value for installment payments for privatized companies. It caused considerable revenues for the government as far as from \$10 million to \$20 million in voucher value could be absorbed (Nellis, 1993).

The major privatization transactions took place from 1996 till 2000 when business and market environment became more stable and well-grounded. Estonian Air, Estonian Telecom, Estonian Railways Estonian Shipping were privatized during this time-period. In 2000 50.4% stake of the Bank of Estonia was sold to Finnish company. So at the beginning of new millennium, privatization process has already been finished in Estonia.

In Lithuania privatization process were divided into two phases. The first period covered the years from 1991 to 1995. “Initial Privatization Program” adopted in 1991 was based on so called mass privatization. Government issued the vouchers and distributed them to the population as a way to get rid of socialist system of ownership “fairly and efficiently” (Hirschhausen, Wan-Sze Hui, 1995). People could buy shares in companies or investment funds either by vouchers or by cash. More than 2.5 million investment accounts were opened in banks. The total value of the

vouchers, accumulated in those investment funds were over LTL 10.2 billion. Foreign investors could participate in sale only with cash. Only 30 % of state enterprises were privatized during the first period of the process. It accounted 81% of the capital offered to private owners. The value of privatized assets was LTL 3.4 billion (Database for Public and Business Administration. [www.balticdata.info](http://www.balticdata.info)).

In 1995 the regulations changed and privatization process became cash based. Foreign and domestic investors were given the same market conditions. According to the new law *on the privatization of state-owned and municipal property* the capital had to be sold in cash. Since 1997 the new government pushed the privatization process further. They announced international tenders on 14 largest enterprise assets in telecommunication, energy and transport sector. Also, half of the assets that had been excluded from privatization were offered for sale. All of these measures explicitly reflected on the dynamics of privatization process. The most important large size enterprises started to be sold since 1997. Lithuanian Telecom, Klaipeda Ship Freight Stock Company "Smelte", AB Vakarų Laivų Remontas (Ship repair yard), Mažeikiai oil refinery-Orlen Lietuva were among them. In 1997 the private sector share in GDP reached 70% (caught up to Estonian indicator). The inflow of foreign investment increased significantly.

Some assets have strategic importance for the country that's why their privatization was politically sensitive issue. Sale of Orlen Lietuva – the only oil refinery company in the Baltic States, caused political controversies in Lithuania. Mažeikių Nafta (former Orlen Lietuva) was first sold to American company Williams International in 1999. It was partially political decision. The phrase of the Lithuanian minister of Economy- “We will not let Ivan near the pipeline” – expressed anti-Russian position. It cost the company quite a lot. Because of energy dependency to Russia, the company ended up with dry pipeline. It experienced huge financial losses during 1999-2002. Lithuanian government asked the American partners to save the company by selling it. Russian oil Company Yukos bought 53.7 per cent of Nafta for \$85 million. As Lithuanian media sources wrote by that time, this sale was “unexpected” and “secretly done”. Later on the Polish company made a deal with Yukos and Lithuanian government and bought 53.7 (out of Yuko's share) + further 30.66% from government share. The privatization of Mažeikių Nafta is sometimes assessed as “notable failure” (Kasekamp, 2010).

Privatization of agricultural units carried out with impediments. Overstaffed Soviet-era state and collective farms dissolved. In order to make them viable again, former state farms transformed into cooperatives but did not gain much capital investments for fundamental modernization. Much of the farmland was given to original owners but they were parceled in smaller units than it was in pre-war family farms. In Lithuania, there emerged the problem of productivity in agricultural sector. The percentage of the population employed in the agricultural sectors was quite high while the productivity was comparably low (Kasekamp, 2010).

As far as privatization process heated up with a bit delay, there were over 3000 companies with the value of LTL 5 billion - needed to be privatized by the end of millennium. But the first paces were big. If we observe the dynamics of the private share on GDP, an upwards slope of indicator will be revealed during the late 1990s (Chart 2.3). In 2003 private sector generated 75% of GDP. Latvia lagged behind the neighbors in terms of privatization. The process started slowly and with some delay. Latvia was most industrialized country among the Baltic States. Manufacturing sector was dominated by large enterprises producing specialized goods for Soviet countries. The privatization of large companies was complicated and time-consuming process.

According to the assessment of International Monetary Fund, another obstacle for Latvian privatization process was tight fiscal policy. The layoffs of redundant labor caused considerable fiscal costs (Zile, Steinbuka, 2001).

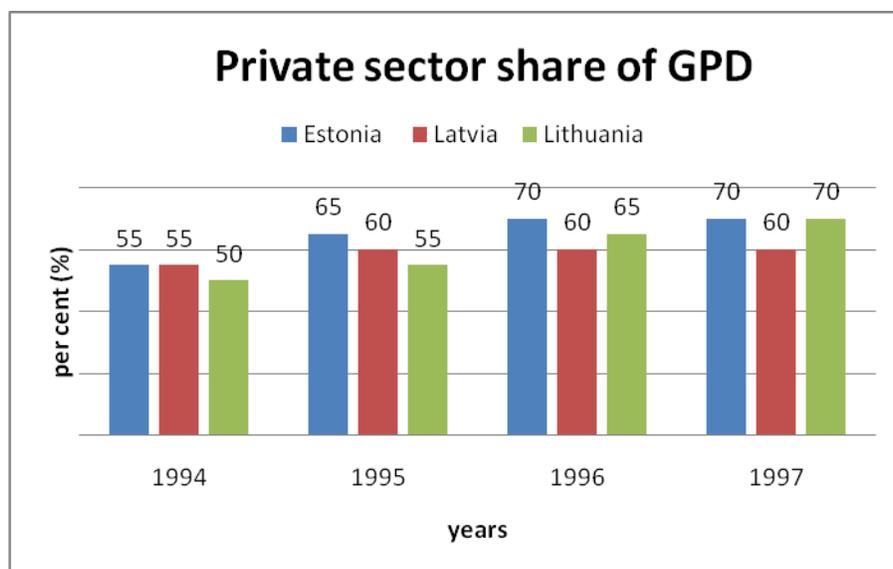
Legal framework of privatization was established in 1991, but the government had limited control over the process, that's why the actual start of the privatization was delayed till 1994 when Latvian Privatization Agency was founded.

Voucher privatization came across the problems of inefficiency. First, it took some time for the government to issue the vouchers but once distributed, it turned out that people tend to purchase housing and land rather than industrial units. As a result, the trading value of the vouchers fell considerably.

Latvian privatization process was also characterized by newly emerged forms of mixed ownership. "Leasing" became quite common practice: private individuals were making a long term lease contracts with the state without strict financial obligations. Leasers could use vouchers and obtain favorable payment conditions for cash transactions. (Hirschhausen, Wan-Sze Hui, 1995). Most of the assets (78%) have been purchased though long term leases.

Consequence to the relatively slow development of privatization process, the Latvian private sector share in GDP lagged behind the indicators of Estonia and Lithuania. By the the time of most intensive privatization – 1997 – Latvian indicator showed 60%, whole Estonian and Lithuanian reached- 70% (Chart 2.3).

Chart 2.3



Source: EBRD Transition Report

At the beginning of the new millennium, Latvian privatization process has not been complete yet. According to the report of European Bank for Reconstruction and Development, in 2003 the share of private sector in GDP accounted 70%.

As empirical analysis shows, Estonia succeeded better than Latvia and Lithuania in privatization process. It can be explained by different initial conditions. Estonia was least industrialized county in the region. The share of Moscow-controlled all-union enterprises was very low. These circumstances made Estonia in privileged position. As Norgaard assumes, “it is generally easier for labor and resource-intensive industries to adjust than for industries demanding large inputs of capital and energy” (Norgaard, 2000). Also, as it has been highlighted above, Estonia was the most radical reformer steering the economy very close to the Washington consensus recommendations.

As Latvia kept close to Lithuania, the Baltic States can be assumed to succeed in speedy and efficient privatization process even though Latvia did not quite managed it.

The speed of privatization program is very important as far as it gives quick start to restructuring process – creation of viable enterprises out of Soviet ruins. It also determines and encourages the inflow of foreign direct investments.

In the late 1990s the Baltic States' economy became investment-driven. They managed to become attractive destinations for foreign direct investments. It was encouraged not only by the intensive privatization process, but also - trade liberalization, low import tariffs and taxation conditions. Estonia was most radical in these terms. Import tariffs were abolished and quantitative import restraints totally rejected. International Monetary Fund suggested the imposition of import tariffs in order to collect state revenues. The tariffs had to be low and uniformed accounting approximately 10-15 per cent (Aslund, 2007). But Estonian local authorities tended to adopt more radical policies than recommended by international financial institutions (Norgaard, 2000). Latvia and Lithuania chose domestic protectionist policies by imposing tariffs on importing goods. The rate varies according to the countries of origin and the importing product types.

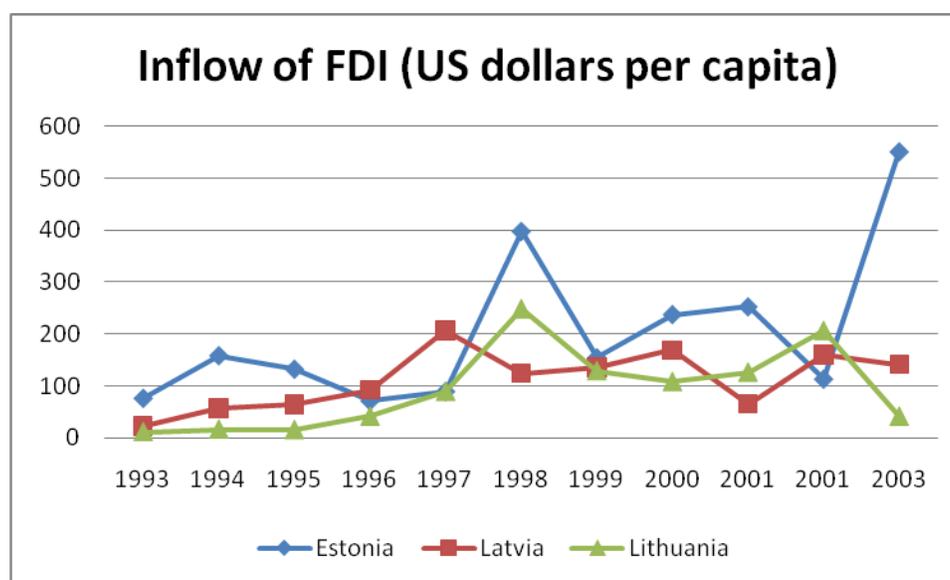
In terms of taxation, Estonia was the first country among the Baltic States which introduced a single Personal Income Tax (PIT) with 26 % rate in 1994. Latvia and Lithuania soon followed the suit by introducing flat rate taxes. In 1999 Estonia abolished the tax on reinvested earnings. It helped the accumulation of domestically-generated capital and encouraged reinvestments.

As it was mentioned above, privatization, trade liberalization and favorable business taxation considerably improved investment climate. The convenient geographical location, relatively moderate wage costs and growing market potential appeared to be other motivating factors for foreign direct investments. Since 1993 increasing dynamics of foreign direct investments is observable in the Baltic States. Especially the second half of 1990s is marked by intensification of FDI inflow (chart 2.4).

Estonia as a leading reformer started to be the receiver of FDI earlier than Latvia and Lithuania. Latvia and Lithuania were dominated by equity capital, which means that most of the investments were directed to the creation of new firms. On the contrary, Estonia had very big share of reinvested earnings because of the comprehensive corporate tax system (ECOFIN

Country Focus, 2010). Also, the share of foreign direct investment as a percentage of capital formation was significantly bigger in Estonia (35%) than in Latvia (8.4%) and Lithuania (17.3%) (Lane, Myant, 2007).

Chart 2.4

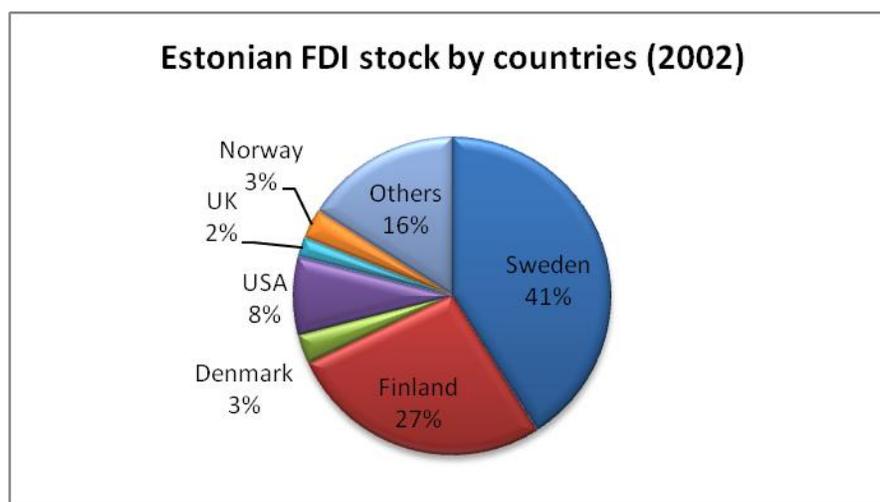


	1993	1994	1995	1996	1997	1998	1999	2000	2001	2001	2003
Estonia	76	158	132	71	89	397	154	237	252	113	550
Latvia	22	57	64	92	206	124	136	169	65	160	141
Lithuania	11	16	15	41	89	249	129	108	126	207	41

Source: EBRD Transition Report

If we analyze the FDI shares by sector and the countries of origin, one significant tendency will be revealed – Nordic countries (Sweden, Finland, Denmark, and Norway) were the main contributors of capital formation in the Baltic States (Chart 2.5). Sweden and Finland accounted 40.9% and 26.9% of total FDI in Estonia by the year of 2002. Total share of the four Nordic countries exceeded 70%. Main investing sector in Estonia was *finance*, accounting 27.4% of the total share of FDI. The key explanatory fact behind the picture is the presence of Nordic banks (Nordea, Sampo, Swedbank, SEB etc) on Estonian market. Financial intermediaries were followed by *transport and communications* sector (22.6%), *Manufacturing* (18.7%) and *wholesale and retail* (13.4%) (indicators of 2002) (Database for Business and Public Administration, [www.balticdata.info](http://www.balticdata.info)).

Chart 2.5



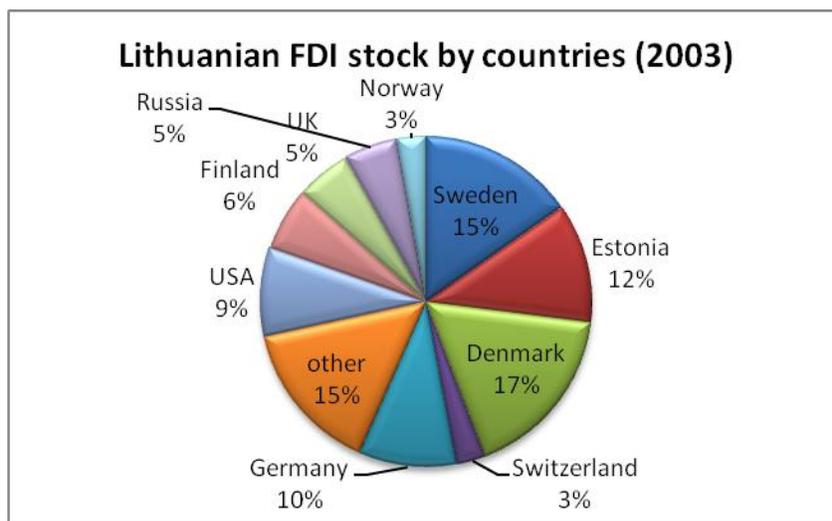
Source: Database for Business and Public Administration <http://www.balticdata.info/>

Besides, Estonia was one of the major investing sources in Latvia and Lithuania. 11.7% of Lithuanian cumulative FDI was represented by Estonia in 2003. In Latvia the same indicator showed 6.3%.

In the early 1990s, Lithuania received significant amount of investments from the United States, but in the following years, America's leading position was overtaken by Sweden and Finland as a result of Telekomas privatization deal (Chart 2.6). In 1998 60% stake in the local telecommunication monopoly - Lietuvos Telekomas was sold to a consortium of Swedish Telia and Finnish Sonera for \$550 million. (Multilateral Investment Guarantee Agency, [www.fdi.net](http://www.fdi.net)). Significant share of FDI came from Denmark. Danish investments in Lithuania were represented by TDC (Tele Danmark) provider of communication solutions. In 1999 Tele Denmark became the shareholder of two Lithuanian cellular companies - Bité GSM (71.6%) and Comliet (49%). (Tele Denmark press release 1999, [www.tdc.com](http://www.tdc.com)).

Most attracting sector of investment was industries. 18.3% of total Lithuanian FDI was accumulated in *industrial sector*. It was followed by *transportation and storage* (13.1%), *electricity, water and gas supplies* (10.5%), *construction of residential housing* (10.0%), and *post and communications* (8.9%) (Database for Business and Public Administration, [www.balticdata.info](http://www.balticdata.info) indicators of 2002).

Chart 2.6

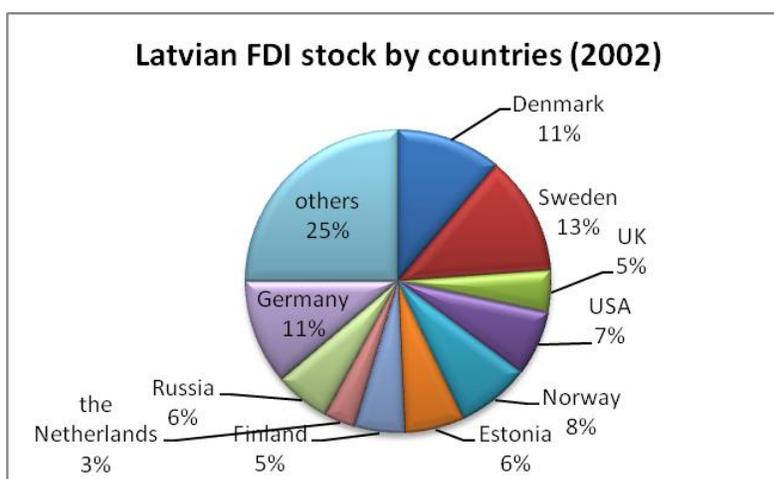


Source: Database for Business and Public Administration <http://www.balticdata.info/>

Latvia is also dominated by Nordic investments (Chart 2.7). The largest Finnish investment was done in 2000 when Latvian government privatized local telecommunication monopolist-Lattelkom. Sonera's \$305 million investment was done via Sonera's Danish subsidiary Tiltis Communications. Thus, the share of Danish investments has increased.

In terms of sectoral distribution, Latvian FDI was mostly distributed among the following spheres: *manufacturing and industry* (23%), *finance* (22%), *retail and wholesale trade* (20%) *transport and communications* (19%) (Database for Business and Public Administration, [www.balticdata.info](http://www.balticdata.info), indicators of 2000).

Chart 2.7



Source: <http://www.balticdata.info/>

How these developments impacted on the recovery of economy? As economists assume, there is a positive link between GDP growth and an extant of private sector. Empirical analysis shows that the fastest growing economies are the biggest recipients of foreign direct investments. The Baltic States' governments carried out the the reforms zealously. They managed to build market institutions successfully but well-functioning of economy was considerably depended on corruption level. Corruption or state failure tended to be unbeatable problem for many transition countries as far as it was very common practice in the Soviet Union. It became the challenging issue for the Baltic States as well.

The continuation of Soviet-time corruption was expressed in the spread of rent seeking practices in most of the transition countries. As Anders Aslund assumes, "post-communist transformation is the history of the war for and against rent seeking" (Aslund, 2007). Rent seekers were former Soviet officials who started to make money out of market and state failures. They benefited from inconsistencies of the transitional system by trying to gain control over unguarded resources (Aslund, 2007). They were engaged in politics and kept close ties to business and enterprises. Rent seekers (future oligarchs) supported gradualist reforms as far as partial establishment of market institutions and hybrid political regime would leave bigger maneuvering space them.

According to the Transparency International (1999) Corruption Perception Index, Estonia is perceived as least corrupt among Eastern European and former Soviet States. Estonia created good legal basis for erosion of corruption practices. The Law on Corruption Prevention was passed on January 19, 1995. It deals with the economic interests of government employees. "Civil servants must declare their sources of income – including property, shares or interests in business, and gifts that they have received – and they may not make or influence decisions in which there may be conflicts of interest" (Nations in Transit, 1998). According to Estonian legislation, corruption is treated as a crime under criminal law.

According to the Nations in Transit report (2004), there were three major reasons for Estonia's low level of government corruption:

- 1) The EU accession process – "EU considers the fight against corruption in new member states to be "a vital element in building administrative capacity, strengthening the judiciary and ensuring financial control" (Nations in Transit 2004)

- 2) Free economy based on laissez-faire principles – Estonia put much effort in removing the vestiges of the old Soviet system soaked with corruption.
- 3) Degree of intolerance among the general population for official corruption – Estonian people do not trust government officials. They demand official information about public figures. (Nations in Transit, 2004).

The situation in Latvia and Lithuania was not that alluring. International organizations heralded considerable level of corruption in both countries. Even though the legal basis was properly established, the laws were hardly exercised in practice. Nations in Transit report (1998) states that in Latvia “checks on the observance of anti-corruption regulations revealed that half the cabinet and nearly one-third of all deputies had violated the law by holding positions in private business” (Nations in transit, 1998). Fight against corruption did not abate though. Corruption Prevention and Combating Bureau (KNAB) has been operating in Latvia since 2003. It uncovered several corruption cases. The situation started to improve slowly. Nations in Transit report resumes that by 2004 “there has been a perceptible change of mood in the country that corrupt practices will no longer be ignored and tolerated” (Nations is Transit, 2004).

In Lithuania the situation was a bit better than in Latvia, but still corruption and bribery were quite entrenched on government level. In 1997 conservative government introduced anti-corruption campaign -“clean hands” in order to exercise tight control over government operations. But Transparency International evaluated the policy as “appropriate but not yet sufficient” for tackling corruption problems.

In 2003 several scandals burst around regional and central government officials. Large-scale investigations started around more than 3000 land officers who were suspected in abusing power in the process of land restitutions. They acquired land for extremely low prices. Some of the governors were found officially guilty and sent to prison.

It turned out that Soviet legacy was more deep-rooted in Latvia and Lithuania, than in Estonia. The “soviet way of doing things” was not easy to eradicate. The social mentality is hardly transformable. Institutional reforms are very important but nothing could be fundamentally changed without “new blood”, new generation. In my view, this was the case of Lithuania and Latvia. Estonian society and government turned out to be more ready and mobilized for changes. They did maximum that have ever been done in any other transition countries, but Estonia

managed to reach the level “less corrupt than the most corrupt Western European countries” (Aslund, 2002).

The empirical indicators of corruption level in Baltic States in summarized in table 2.1.

Table 2.1. Corruption level in the Baltic States

(Corruption perception index on 10 point scale where 10=very low level of corruption, Rank among 133 countries)

	1998		2000		2002		2004		2005	
	Score	Rank								
Estonia	5.6	26	5.7	27	5.6	29	6	31	6.4	27
Latvia	2.7	71	3.4	57	3.7	52	4	57	4.2	51
Lithuania	?	?	4.1	43	4.8	36	4.6	44	4.8	44

Source: Global Corruption Report [www.transparency.org](http://www.transparency.org)

To be back to the main research question, why the transition was successful in the Baltic States, the processes described above, give partial answer: they chose an appropriate strategy of economic changes, shock therapy turned out to be the right way, even though the same strategy failed in some other transition countries. The Baltic States managed to mobilize all the resources and accepted the challenges of severe reforms. The final destination – integration into European economic system was achieved. It helped them to progress more and catch up with the “old Europe”. The further success is expressed in economic freedom indicators of 2007-2009 where Estonia and Lithuania are ranked among the mostly free economies; Latvia follows them in the group of moderately free countries (Table 2.2)

Table 2.2. Index of Economic freedom 2007-2009 (scores on 100-point scale)

	Aggregated index		
	2007	2008	2009
Estonia	78	77.8	76.4
Lithuania	71.5	70.8	70
Latvia	68.2	68.3	66.6

Table 2.2 (I) Scores of subindices

	Scores of subindices									
	Business freedom	Trade freedom	Fiscal freedom	Government size	Monetary freedom	Investment freedom	Financial freedom	Property rights	Freedom from corruption	Labor freedom
Estonia	75.9	85.8	81.5	67.3	79.7	90	80	90	65	48.5
Lithuania	82.4	85.8	87.6	65.3	75.8	70	80	50	48	54.6
Latvia	73.8	85.8	82.3	58.5	71.1	70	60	55	48	61.6

Source: [www.heritage.org](http://www.heritage.org)

## Chapter III

### Political Transition

#### 3.1. Common Heritage – Link for the Future Cooperation

The Baltic States were the only post-soviet countries with democratic experience before the annexation in 1940. Estonia, Latvia and Lithuania emerged on international level as independent, democratic countries after the World War I. They adopted their own constitutions and established parliamentary regimes. Democracy turned out short-lived there: in Estonia and Latvia it lasted till 1934, in Lithuania - till 1927-1929. “Era of silence”<sup>6</sup> was overtaken by Soviet occupation.

The restoration of independence in 1991 opened a new page in the history of the Baltic States. They had to redefine themselves on political map of the world. Having experience of independent statehood and democracy during the interwar period, the Baltic States firmly set the future objectives: democracy, integration in Europe, establishment of western political institutions. They were mature for full democracy. Before I describe the process of democracy building in the Baltic States, I would like to draw the contours of emergence of the Baltic region as such.

Common historical destiny and common view of the future made the Balts consolidate and stand for the future aims together. “The “Baltic Way” of the human chain from Vilnius through Riga to Tallinn of 23 August 1989 struck a chord with the people in the West. In the course of the independent movement Latvians, Lithuanians and Estonians began to be proactive in using the term “Baltic” and began to have a consciousness of solidarity” (Shima, 2007). Being on the crossroads of eastern and western civilizations, the Baltic countries realized the international value of the regions as a whole. They saw the chance to be the Western window to the East. This fact encouraged the regional cooperation between them.

According to Berg, Latvia was the strongest promoter of Baltic Sea regional cooperation, because the other two- Estonia and Lithuania had alternative ties to their neighbors. Estonia was

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<sup>6</sup> The phrase comes from Estonian history, describing the years 1934-1940. It is connected to the breakdown of democracy after Estonian coup d'état in 1934. When the dictator Konstantin Päts came to the power, opposition and Society “went silent”.

“embraced” to Finland, while Lithuania chose to make alliance with catholic Poland rather than Orthodox Russia back in 14<sup>th</sup> century.”The whole debate about Estonia’s future orientations became a desperate attempt of “*drang nach Norden*” in the series of brand-making/image creation exercises to portray Estonia as a post-communist Nordic State with a Scandinavian style cross-flag and “Estland” as the state name. Lithuania’s close association with Poland encouraged the idea that her route to “Europe” should be through Warsaw. This neglected the obvious fact that Lithuania, like Poland is both a Baltic and a Central European state, and that her interests require her to keep both avenues open” (Berg, 2007). Despite this, the idea of an “Amber Gateway” based on strong Baltic regional cooperation was widely supported and further developed by “the three sisters”.

To be back to the process of democracy-building in the Baltic States, we should highlight the fact that political transition from communism to democracy was based on the basic pillars:

- 1) **Nation-building** – the main goal is to raise national self-awareness, determine national identity and secure the niche on the map of nation-states.
- 2) **State-building** process encompasses so called “high” politics: government, presidency, parliament, corporate groups. The essence of the process is the implementation of institutional reforms on government level, rearrangement of political party system, decentralization of power among political institutions and formation of democratic legal system. Policy-making process is in hands of above-mentioned political bodies, thus their role of the country’s political future is crucial.
- 3) **Society-building** is about the formation of civil society. How people understand the role of politics? Are they aware of their share of responsibility and power in political decision-making? Are they willing to participate in political processes? The emergence of non-profit sector (non-governmental organizations, civil society organizations etc) contributes to the development of society building process.

### **3.2. Nation-building Process**

The core question around nation building process is: *Who are we* and *where do we belong?* Relocations on “the great chessboard” after the dissolution of the Soviet Union raised these questions at the very top of the Baltic States’ political agenda. They had to redefine their cultural

belonging and make distinctions between “us” and “them”. Being geographically nested among Russia, Scandinavia and Europe, the Baltic States have been the “land of contacts and contradictions” (Berg, 2007). After regaining independence in 1991, the meaning behind the notions - “us” and “them” was widely demonstrated: the former referred to the “west” and the latter –“east”. There were two options of belonging: either Russia or Europe. Historically the Baltic States were the battlegrounds for different European powers, consequently western cultural influence and the sense of belonging to the West was considerable. Due to the secret protocol of the Molotov-Ribbentrop pact of 1939 followed by annexation in 1940 the Baltic States fell into the hands of the Soviet Union. The effect and leftovers of five-decades-long incorporation into the Soviet Union was quite strong as well. If we quote the words of Estonian president Meri, “On one side is Europe, on the other side – Russia. We are on the border and therefore only a small push is needed to to make us fall into one side or rise into the other” (Berg, 2007).

The turbulence around the topic of national belonging was aggravated by the demographic situation. Demographic picture of the Baltic States before and after the Soviet rule differed dramatically. In the World War II the Baltic States’ titular nations experienced considerable human loss, also, the mass deportations of Stalinism epoch contributed to the significant decrease of ethnic Estonian, Latvians and Lithuanians living in their homeland. On the other side, the number of Russian minorities has increased considerably due to the intensive immigration during the Soviet times. Table 3.1 clarifies the picture of demographic changes in the Baltic States.

Table 3.1 Baltic Demography. The 1920s and 1930s versus the 1980s

Group	percentage					
	Estonia		Latvia		Lithuania	
	1934	1984	1939	1989	1923	1989
Titular Nation	88.8	61.5	75.5	52	69.2	79.6
Russians	8.2	30.3	10.6	34	2.5	9.4
Ukrainians &Byelorussians	NA	4.9	1.4	8.0	NA	NA
Poles	NA	NA	2.5	2.3	15.3	7.0
Jews	NA	NA	4.8	0.9	8.3	0.3
Germans	2.2	0	3.2	0.1	NA	NA
Lithuanians	NA	NA	1.2	1.3	---	---
Other	0.8	3.3	0.8	1.4	4.7	4.0

Source: Juan Linz & Alfred Stepan Problems of Democratic Transition and Consolidation: Southern Europe, South America and Post-Communist Europe (Baltimore & London: Johns Hopkins University Press)

The process of nation-building was mainly constructed on codification of social boundaries and making distinction between homeland nations and minorities (Smith, 1999). As it is observed from the statistics on demography, Latvia and Estonia inherited the most complicated situations. The key problematic point was the homogeneity of minorities with significantly big percentage of Russians. According to the 1989 census, more than half of the population in Tallinn was Russian-speaking, Narva, the northeast border town with Russia, had 94% of Russian-speaking population, in Latvia the most Russian-inhabited cities were: Riga, Jelgava, Ventspils, Liepaja, Rezekne, Jurmala and Daugavpils. The last two of them had respectively 53% and 87% of Russian speakers by 1989 (Linz, Stepan, 1996). In contrast, Lithuania ended up with relatively small proportion of non-Lithuanians and much more heterogeneity of the overall picture. That's why Lithuanian authorities were tolerant to minorities, granting them generous citizenship rights.

According to the 1989 Law on Ethnic Minorities, non-titular ethnic groups were given the right to learn and be educated in their own languages, practice their religion and belong to their ethnic organizations (Lane, 2001). So we can assume that Lithuanian government was quite tolerant towards the minorities but it does not mean that it encouraged the creation of “Diaspora units”. We should keep in mind that the main point of the tolerance as such, is that the state provides the legislative basis to prevent any kind of discrimination or exclusion, but it also **expects** some sort of adaptation from the minorities. To put in differently, government hopes that the fair treatment to the minorities will make them as loyal citizens to the titular state.

Was it possible to make Russian-speaking minorities loyal to independent Latvia and Estonia? What was the main obstacle and what kind of strategy did the governments choose to deal with the problem? I would seek to answer these questions based on Estonian and Latvian case studies. In order to become loyal citizens of the Baltic States, it was assumed that minorities had to assimilate into democratic nation-states of Latvia and Estonia. We can distinguish two types of assimilation: cultural and political. The process of assimilation does not have to be on-way-road. The state should guarantee the cultural and political freedoms and minorities should be willing to adapt the dominant nationality. Only in this case the assimilation is more expected.

Linz and Stepan assume that Russian minorities in Latvia and Estonia were politically assimilable but culturally-not. Opinion polls showed that majority of them gave their first identity to the the state they resided. According to 1992 census indicators “only 4.2 per cent of the Russian speakers in Latvia gave as their first identity Russia, whereas 53.2 percent gave as their first identity the republic in which they resided. Among Russian speakers in Estonia, the proportions were respectively 12.0 and 38.3” (Linz, Stepan, 1996).

Weak identification with Russia among the minorities can be rooted to the Soviet history. “Let us not forget that a central element of Russian national-cultural identity, Russian Orthodoxy was persecuted, destroyed and “privatized”...Russian history was submerged in Soviet history textbooks” (Linz, Stepan, 1996). As a result, Russian-speaking minorities turned to be highly localized and centered on the external homeland (Smith, 1999). And, they simply saw their personal career opportunities as better within the Baltic States than in independent Russia.

Interesting point is that not many of them favored for the independence of the Baltic States. They preferred preserving the status of independent republic in the frame of the Soviet Union (Linz, Stepan, 1996), while the aspiration of the Balts towards independence was super-high.

The problem with cultural assimilation was the lack of titular language knowledge. Majority of the minorities were able to speak only Russian (Table 3.2). Linguistic distance, especially between Estonian and Russian is quite big. In the soviet times there was not much need to know the Baltic languages because of the dominance of Russian throughout the empire. After the emergence of independent Baltic States and awakening of their nationalism, the knowledge of titular languages became essential for cultural integration and for acquiring social welfare as well.

Table 3.2. Language Knowledge in the Baltic Republics (Reported in 1992 Interview) by language used in the interview

Language knowledge	percentage					
	Estonia		Latvia		Lithuania	
	Estonian	Russian	Latvian	Russian	Lithuanian	Russian
Only Russian (or non-Baltic language)	---	45	---	33	---	22
Only Baltic language	74	1	52	4	64	4
Baltic language and Russian (or other non-Baltic language)	26	54	48	64	36	74

Source: Juan Linz & Alfred Stepan Problems of Democratic Transition and Consolidation: Southern Europe, South America and Post-Communist Europe (Baltimore & London: Johns Hopkins University Press)

As far as the extent of cultural assimilation was limited, there emerged so called “second class citizens”. The term was addressed to the people who were unwilling or unable to assimilate. The key point with their conditions is that they are less likely to return to the historical homeland (Russia, in this case). So they are eager to stay but unable to assimilate. Here comes the question of the government policy towards them.

It will not be exaggerated if we say that Estonian and Latvian governments were very strict and intolerant towards minorities. They chose exclusionary policy of citizenship rights. It means that minorities are isolated from political process, deprived of the voting rights, thus they have no influence of political decision-making. The issue of granting official citizenship to the minorities was the matter of big discussions and resistance. According to Estonian legislation, citizenship could automatically be given only to those individuals, who were born in Estonia before 1940 or had Estonian pre-annexation-born ancestors, all the rest could opt to either for Russian citizenship or apply for Estonian citizenship through naturalization. The conditions of naturalization were codified in the Citizenship Act (passed in 1995). Paragraph 6, *Conditions for acquisition of Estonian citizenship by naturalization*, states that an alien, who wishes to acquire citizenship through naturalization, shall have the knowledge of Estonian language. This requirement became insuperable obstacle for most of citizenship-seekers. As far as Soviet citizenship lost its legitimacy and the other option – getting Estonian one – was almost impossible, most of the Russian-speaking minorities turned out to be with undetermined citizenship status. In 1992, 32 percent of the whole populations belonged to this category.

Interesting fact is that during the first five years of independence, Estonian minority policy lacked the political stance, official statements and programs which would define the future prospects of their full integration. Legal rules were not accompanied by the statements that would clarify the goals of the policy. As Lauristin assumes, this “official silence” was not deliberate, political elite simply did not have the firmly-set agenda how to deal with the problems. This situation resulted in increasing uncertainty and fear among the Russians. “It was usual in those times to suspect some sort of hidden agenda concerning open repatriation or indirect expulsion”(Lauristin, Heidmets 2002). The first official statement appeared in 1998 under the title “Integrating Non-Estonians into Estonian Society: Setting the Course”. The document declared government’s will to support the integration process. It also set an agenda how the progress could be achieved in this field. The document was initiated and widely elaborated by civil society servants, social scientists and researchers. This fact emphasizes the importance and effectiveness of civic participation in political decision-making.

Different from Estonian model, Latvian legislation introduced quota system of the citizen-policy in which the number of non-citizens to be naturalized each year was limited by means of so

called “naturalization windows”. 1994 parliament decree permitted only 0.1 per cent of Latvian population (2000 persons) to be naturalized annually (Smith, 1999).

Behind this attitude one can easily see that the Russian minorities were treated as illegal migrants. The moral right to restrict citizenship to Russian-speaking minorities laid in collective memory of the Baltic States: as far as they were incorporated into the Soviet Union involuntarily, those people who settled in Latvia and Estonia during the years of occupation could not be fully pledged citizens of the state they resided. Also, it was assumed that minorities carried the threat for national dignity especially for such small countries as Latvia and Estonia. It is assumed that this kind of exaggerated fright was inertial movement coming from five-decades-long facing near cultural genocide. But in reality, those Russians who turned out to be minorities after the dissolution of the Soviet Union could not carry any threat for cultural self-preservation because of the weak sense of communal identity. Even though they might feel more cultural affinity to the homeland than residing state, borderland Russians never formed strong Diasporas (Smith, 1999).

It is argued that political reasons behind the minority policy were much stronger than cultural justifications. Borderland Russians are often times used as a tool for political manipulations by Russian political elite in order to preserve the influence on post-soviet sphere or so called “near abroad”. This idea is further developed by Smith:

*“The nature and extent of the regimes’ nationalizing projects can only be fully understood in relation to the way in which Russia is represented in the mid-sets of the borderland states. Equally, Russia’s interests and actions with regard to the near abroad will be shaped by Moscow’s portrayal of the borderland regimes and, in particular, of the place it ascribes to Russians living in the near abroad as part of its own sense of nationhood” (Smith, 1999).*

So the strategy-choice of Latvia and Estonia was dictated by their national security interests; minorities turned out to be the “victims” of regime-change or to say in different way, “losers of transition”.

Exclusionary minority policy turned out to have a conflicting logic with liberal democratic values in Latvia and Estonia. It was obvious from the very beginning that in terms of minority issues, Latvia and Estonia opted for ethnic democracy rather than liberal, multicultural, partly

bilingual society with minimum demands of cultural integration. That's why Russia raised the issue of human rights violations and demanded international attention for that. Harsh reaction from Russia was easily predictable, but western international and transnational organizations were quite critical as well. Unfair treatments towards the minorities jeopardized the Baltic States' future membership of the Council of Europe and obviously, European Union as well. Finally the governments compromised and moderated the legislations. In 1998 Estonian Parliament - Riigikogu passed an amendment to the Citizenship Act, simplifying the naturalization for stateless children born in Estonia after 26 February, 1992. The amendment codified that the children whose parents of undetermined citizenship have lived in Estonia for at least five years, were no more required to pass the citizenship examinations. Also, Riigikogu adopted several simplification procedures step by step. (For example, time for obtaining citizenship was shortened, costs of language courses reimbursed, charge for taking language examination abolished etc). As a result the share of persons of undetermined citizenship decreased to 12% in 2003 (Estonian Foreign Ministry and Enterprise Estonia [www.estonia.eu](http://www.estonia.eu))

Supporting the recommendation of OSCE, Latvia abolished the "naturalization window" in 1998. Latvian parliament - Seima followed the suit by granting the citizenship without examination requirement to the stateless children born in Latvia since August 21, 1991. As a result, number of people who acquired Latvian citizenship through naturalization in 1999 was almost triple (12427 persons) that of previous year (4439 persons in 1998) (Latvian Office of Citizenship and Migration Affairs [www.pmlp.gov.lv](http://www.pmlp.gov.lv)).

Interesting fact is that most of the minorities expressed positive attitude towards the integration into the European Union hoping that European structures would become the guarantors of their citizenship rights. This attitude was not groundless because European Institutions were concerned about the compliance of Eastern Europe with the West's political agenda of human rights. Actually statistical data shows that in 2004 (When Baltic States joined the European Union) the number of persons who acquired Estonian and Latvian citizenships through naturalization was almost double than the previous year. In Estonia 6523 persons were granted citizenship status in 2004, while the same indicator for 2003 was 3706 (Estonian Foreign Ministry and Enterprise Estonia [www.estonia.eu](http://www.estonia.eu)). In Latvia the numbers were respectively 16064 - in 2004 and 1049 - in 2003 (Latvian Office of Citizenship and Migration Affairs

www.pmlp.gov.lv). As far as Estonian and Latvians automatically became the citizens of European Union obviously the appeal to get a citizenship of the resident state has increased.

In conclusion we can say that nation-building process in the Baltic States was not smooth and painless. National interests came across the conflicting logic of democratic principles. As far as the minorities were deprived of the citizenship and voting rights, they obviously could not participate in political decision-making process. This was the central problem of building well-functioning democracy and civil society. As Lauristin writes “It became clear that the transformation to democracy was impossible without a strong and effective civil society, which would provide its citizens with opportunities for participation and would give them a role in the decision-making process.” (Lauristin, Heidmets, 2002). Different from the Lithuanian government who chose the inclusionary citizenship policy towards minorities and avoided the complications from different ethnic groups, Latvia and Estonia challenged a big resistance and political turbulence from the ethnic minorities, Russia and international organizations. But with the help of external recommendations and internal will to tackle the problem they managed to overcome the major shocks and reach at least the necessary level of achieving final goal-membership of the European Union.

### **3.3. State-building Process**

The process of state building encompassed the rearrangement of political institutions and implementation of democratic state system. The Soviet legacy of one-party system was rejected even before the official recognition of independence. As far as the Baltic States were sovereign republics during the inter-war period, the fundament of state institutions had to be restored but not built from the scratch. Latvia restored the 1922 constitution, added modernizing amendments and adopted it in 1993 by referendum. Lithuania and Estonia drafted new constitutions that were approved in 1992 in national referendums as well. The fundamental legal document defined the functions and responsibilities of the government branches. The head of the state is president elected for five year-term in Estonia and Lithuania and for four year-term - in Latvia. Lithuania chose the semi-presidential model with directly elected presidency, while in Latvia and Estonia the systems are centered on parliament which has authority to elect the president. (Kasekamp,

2010.). So in this term the Baltic States followed the suit of Western democracies but the picture of party systems was more diverse and complicated.

In Estonia the dominance of the Communist Party was terminated by the amendment of 23 February 1990. It opened up opportunities for the various parties to emerge on the political scene. Nonetheless these newly-founded political parties had some sort of “ancestors” existing in forms of popular movements. The popular political movements first appeared in 1980s and put the legal and political unity of the Soviet Union under question. They were not radicalism movements; rather centered on the question if Estonia should seek for full independence or extended autonomy within the Soviet Union.

One of the first political alliances was *Eestimaa Rahvarinne*, the Popular Front, formed as an umbrella organization in 1988. Even though they supported moderate strategies in terms of independence and kept ties with the Communist Party, “the initial aim was to unite most of the population to provide a platform for democracy, and to achieve more autonomy” (Lagerspetz, Vogt, 2004).

Another major political alliance was Estonian Citizens’ Committees (*Eesti Kodanike Komiteed*) which was composed by radical dissidents, who, different from *Rahvarinne* members, demanded full restoration of the first Estonian Republic. Those two popular movements backed the two major governmental bodies by that time: Estonian Council - dominated by Estonian Citizens’ Committees as a result of 1990 elections (174 seats out of 499) and the Supreme Council - represented by the majority of *Rahvarinne* representatives. The strategies of those two movements were neither identical nor conflicting. The meeting point of their fundamental goals was sovereignty and independence of Estonia that was finally voted for in the 1991 national referendum by the majority (83 per cent) of Estonians (Lagerspetz, Vogt, 2004).

The first founding elections of independent Estonia was held in 1992. The participant parties originated from the above-mentioned political movements. They were reorganized in electoral alliances in order to get over the 5 per cent electoral threshold. The electoral alliance Pro Partia (*Isamaa*) which became the winner of the first elections consisted of five parties, out of which four originated from Citizens’ Committee. The alliance was led by the members of Estonian Christian Democratic Union – Mart Laar, Trivimi Velliste and Illar Hallaste. They were young émigrés, supporting radical free market economy reforms. The newly elected president Lennart

Meri was also right-wing politician, with long-time experience of living abroad, polyglot and film-maker. Laar became the prime minister. Kasekamp assumes that those persons who came to the top of the government determined the success of Estonia's political transition. He claims that after 1992 election "Estonia made the clearest break with the Soviet past" (Kasekamp, 2010).

Following elections changed the picture of Estonian political spectrum. In 1995 the majority of seats (41 out of 101) on *Riigikogu* were taken by Coalition Party led by Tiit Vahi. The government coalition was formed with the Center Party and then with Reformist party, founded in 1994 by Siim Kallas, then president of Estonia's Central Bank. Pro Partia got only eight seats out of 101.

In 1999 elections Pro Partia managed to succeed again, because soon before the elections it merged with Estonian National Independent Party to form Pro Partia Union (*Isamaaliit*). Pro Partia Union got 18 seats in *Riigikogu*. Mart Laar became the prime minister again. New government was formed with Reform Party and social democrats, with strong center-right orientation. The coalition did not last long successfully, because Pro Partia Union "suffered from fluctuations of popular support" (Lagerspetz, Vogt, 2004). In 2003 it hardly managed to get over 5 per cent threshold.

Reform Party emerged as considerable force on Estonian political arena. It has been in the government since 1995 and almost all the time deserved the populist support from the electorate. The Party program was based on the issues that were crucially important for the public by that time. It was more concentrated on economic and social reforms and supported neoliberal policy. The party leader Kallas, initiated the abolishment of corporate income tax which was actually achieved in January, 2000. It is assumed that populism, that was strong feature of newly formed political parties in post-communist regimes, was least characterizing for the Reform Party. It had pragmatic and realistic policy to restore the social order and tackle the problem of "two Estonians". The government headed by the Reformists announced the need to bridge the gap between people and government, speed up the reforms in public administration, health care, pension insurance, and family policy and so on (Lauristin, Vihalemm, 2009). Expectations from the society were super high, that's why the Party almost never faced the problem of getting seats in the Parliament.

Even though the party system in Estonia was not stable and mainly formed around personalities rather than socio-economic cleavages (Kasekamp, 2010), time by time the tendency of professionalization of politics became apparent. “Intensive institutional learning was needed in order to raise administrative capacity. As the younger generation occupied more and more posts, one could speak about the rise in Estonia of a new political class, uniting the new capitalist elite, party politicians and a new generation of Western-oriented bureaucrats” (Lauristin, Vihalemm, 2009).

Political party system in post-Soviet Latvia lacked consolidation and stability. The frequent changes of party representation in *Seima* with every new election revealed the chaotic character of political landscape.

The first founding elections in 1993 were won by center-right party “Latvian Way”. Guntis Ulmanis, a moderate politician was elected as a president.

In 1995 elections of 6<sup>th</sup> *Seima*, three new political parties got the majority of seats in the Parliament: left-wing Democratic Party "Saimnieks" ("Master") led by a former communist activist Ziedonis Cever; followed by right-wing populist party the Popular Movement of Latvia led by German-Latvian politician Joachim Siegerist; and Latvian Unity Party which gained popular support since the former leader of a leading Soviet-time collective farm, Alberts Kauls, joined this organization (Kalnins, 2001). All of these parties turned out to be short-lived; they dissolved and did not participate in the next 1998 elections. Siegerist’s party was kept out of the office soon after the elections, so its political influence was terminated before the end of 6<sup>th</sup> tenure of Latvian parliament. Its position was overtaken by six-party coalition headed by Andris Šķēle -“a prominent entrepreneur without political affiliation” (Kasekamp, 2010). Andris Šķēle was appointed as a Prime Minister in 1995 but he left the post in 1997 because of the corruption scandal. Soon after the resignation Šķēle formed the political party, the People’s Party which accommodated his political aspirations and won the elections of 1998. Though, the new government was headed by the representative of “Latvian Way” – Vilis Krištopans. One year later, after the expiration of Ulmanis’ second presidential term and election of Vīķe-Freiberga as a head of the State, Andris Šķēle was reappointed as a prime minister. Again, his governing coalitions did not last long and disintegrated in several months as a result of disagreement over

privatization. Finally, “Latvian Way” formed a new cabinet and managed to in the office until the expiration of *Seima*’s term in 2002 (Kasekamp, 2010).

Formation of Latvian political establishment was marked by instability, fragmented party system and frequent changes of leading coalitions or public figures. That’s why the process of institution-formation turned out to be time-consuming. People’s political preferences were motivated by the choice of personalities rather than party policies; consequently parties were built more around the charismatic bureaucrats than programs and values. Populism appeared to be including element of election campaigns. Also, the small membership of Latvian parties indicated the limited linkage to the broader public (Kalnins, 2001).

Paradoxically enough, the first founding elections of Lithuania was won by former communists, renamed as the Democratic Labor Party. The former first secretary of Lithuanian Communist Party - Algirdas Mykolas Brazauskas was elected as a president. Though Lithuanian communist party had deep roots in local history and was not associated with foreign occupation and ethnic Russian dominance. It even helped Lithuania’s break from the USSR and contributed to the demise of the the Soviet Empire to some extent (Kasekamp, 2010).

Party system in post-Soviet Lithuania was widely polarized, but more consolidated than in Latvia and Estonia (Kasekamp 2010). It was classified as two-party system with strong and well-organized left, represented by LDDP (Democratic Labor Party of Lithuania) and relatively weak right, represented by Homeland Union – successor party of *Sąjūdis*, pre-independence reformist movement. Until 2000 these two parties were the power-centers alternatively. Lithuanian political landscape was quite homogenous and stable. After the winning of first founding elections in 1993, Democratic Labor Party maintained the ruling position till 1996. This was quite hard and painful transition time, that’s why the leading party lost the popularity time by time. It never lacked the criticism and suspicions though. Even though LDDP managed to make a break with its own institutional legacy and expressed full commitment to Lithuania’s independence, it was criticized for “Soviet leftovers” such as an influence of former nomenclature members on privatization process. Many scandals burst around corruption practices and non-legal government connections with business. Another wave of criticism was addressed to the poor economic performance. Major economic indicators were negative till 1995. The Right denounced LDDP’s failure to deliver its promises (Lane, 2001). As a result LDDP lost

popular support and in 1996 elections majority of Lithuanian electorate voted for right-wing party– Homeland Union led by Landbergis. The prime minister became Gediminas Vagnorius overtaking the post of Adolfas Šleževičius. Both of them were serving for three years which is quite notable fact because different from Latvia and Estonia, the institute of Prime Minister was more stable and at the same time - more powerful. With the support of absolute majority in the *Seimas* the Prime Minister could make the most important decisions with the president having no power to veto those (Nekrasas). The President did not even have the right to nominate the prime minister after the elections. Šleževičius turned out to abuse the power by making decision independently from the president or the Chairman of the Parliament. He was forced to leave the post because of corruption scandal but his successor Vagnorius maintained the same political power by keeping the close contacts with Landbergis, the leader of the ruling party by that time. Apparently the political weight of the prime minister was determined by his ability to control the ruling party (Nekrasas).

Lithuanian constitution defined the role and responsibilities of the president which was quite different from Estonian and Latvian models. As it was mentioned above, Lithuanian president was not elected by the parliament but directly by the people. According to the constitution, president had to suspend the membership in the Party; he had the power to veto the legislation in the parliament but the latter could overturn it. As it turns out, the power of the president was quite limited in many aspects.

Polarization of Lithuanian political system was once again revealed in 1998 presidential elections. Former communist-party official Brazauskas was replaced by western-oriented Valdas Adamkus. The later did much to enhance Lithuania's bid for Euro-Atlantic structures (Kasekamp, 2010).

The bipolar format of Lithuanian party system has changed since the beginning of the new millennium. In 2000 elections resulted in heterogeneous picture of political scene. Having won the elections, major power moved to Lithuanian Liberal Union and New Union (Social Liberals). The leader of New Union- Arturas Paulauskas who was the main rival of Valdas Adamkus in 1998 presidential elections, became the speaker of the parliament. Rolandas Paksas, the centrist politician from the Liberal Union took the post of the Prime Minister, but he was replaced by Brazauskas next year.

State building process in the Baltic States had one common feature: it was encompassed the personalities rather than social cleavages. Particular politicians had relatively more power than the whole institution as such. The parties lacked the connections with particular groups of civil society, so the transition agenda was “defined from above”. As a result we got the picture of “volatile political party system, with frequent changes in party allegiances by the elected representatives particularly in Estonia and Latvia during the 1990s” (Kasekamp, 2010). On the other hand, relatively stable party system of Lithuania came across the different kind of obstacles – democratic deficit, usurpation of power by particular politicians and circulation of the bureaucrats from one post to another. The problems of state building was rooted in the weakness of civil society which was not able brindle the politicians and restrict an abuse of power. But still we can assume that state-building process did not fail in the Baltic States because institutions were established peacefully without major clashes between different political forces. The process of state-building was progressing and going forward towards full democracy step by step. There were no major attempts to benefit from the euphoria and chaos of transition and “catch the fish in turbid water”. Political and civil society groups took the right path and followed the way till the end.

### **3.4. Society-building Process**

The development of civil society is crucial element for consolidation and the proper functioning of democracy. In democratic regime people influence the decisions that affect their lives. But the question is - how? How can they participate in politics and make the pressure of the top-level decision making process? Those are the questions of public awareness on civil rights and responsibilities. Raising the conscience around these issues makes people involved in politics; consequently it makes democracy stick and work. If democracy is about civic participation and power distribution, communism was vice versa: there was only one center of power - central government; people had no “voice”. Moving from authoritarian system opened the window of opportunity for civic activism and brought the necessity of citizens’ commitment in politics. The resurrection of civic organizing was not so easy especially after decades-long Soviet “brain-washing” but It turned out that the Baltic States were more mobilized and ready for the “second

awakening” than the other transition countries (especially in central Asia and Caucasus) which ended up in “grey zone” instead of democracy.

The role of civil society is expressed in activation of voluntary, non-profit organizations that “shape the society from below” and form a channel of “subpolitics” (Lagerspetz, Rikmann, Ruutsoo, 2002). Resurrection of the third sector was evident by growing number of non-governmental organizations. In Estonia 5700 civic groups and organizations were documented in 1990 (Nations in Transit, 1998). Most of them were concentrated in big cities and the membership was quite high especially among women. The government created favorable legislative environment for nonprofit organizations by allowing easy registration of associations and foundations. In terms of taxation conditions, Estonian nonprofit organizations did not enjoy the automatic tax exemption. They were affected by the two main laws: VAT Act and Income Tax Act stating that NGOs are exempted from VAT only in case they purchase or import goods and services thought non-refundable foreign aid. According to the Income Tax Act only non-refundable financial sources received from donors or from entrance fees are tax exempt. Nonprofit organizations could also apply for tax-exempt status if their activities were connected to charity, science sport, education etc. (Nations in Transit, 1998). NGO sector was not happy with this kind of taxation conditions that actually limited their economic activities. Also, as a result of unfavorable taxation the biggest share of NGO income was coming from foreign assistance while private donations were very low. Financial support from the government was also limited; in 1998 only 50 NGOs received financial assistance from budget.

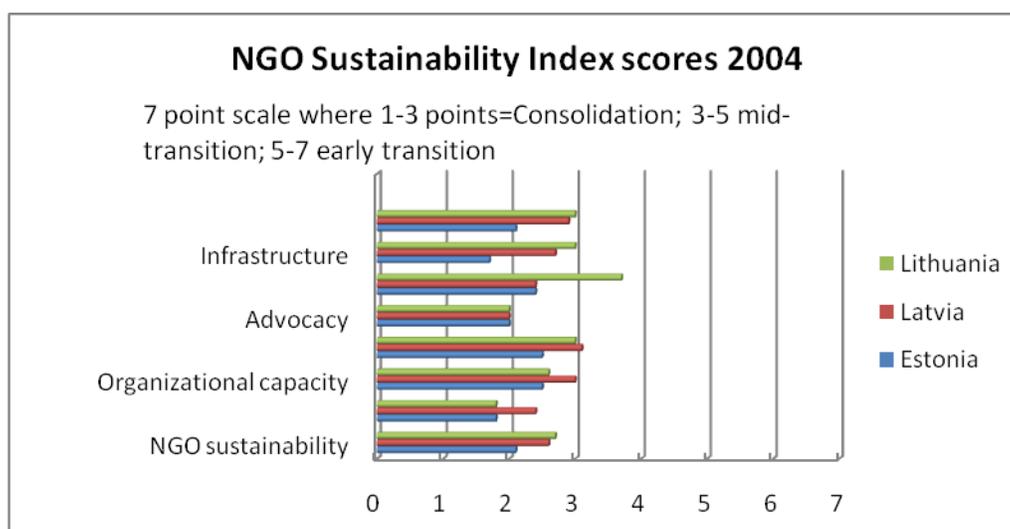
Another challenging issue for the NGO sector was organizational capacity. Most of the employees lacked the qualification and experience in proposal writing, accounting tasks, budget elaboration. International assistance was quite considerable in this aspect. Trainings and conferences provided by international partners were focused on the topics of fundraising, grant-proposal writing, public relations etc. Also, many websites were created and developed where people are involved in presenting and commenting on the third sector in Estonia (NGO sustainability Index 2004). For example, one of the websites was created by Estonian Law Center Foundation as a bridge between government and population. NGO representatives started to cooperate with political parties expressing the issue position of the group (Nations in Transit, 2004).

As a result of hard internal efforts and intensive foreign assistance Estonian nonprofit sector revealed enormous progress at the beginning of new millennium. The legislation improved thanks to the development of the Estonian Civil Society Development Concept (EKAK) that was adopted by the parliament in December 2002. More and more people got employed in civil sector. Not only the number of nonprofit organizations increased but also the affect and extent of the activities they were carrying on. Different from the early 1990s when many NGOs were registered only for the maintenance of real estate, since late 1990s increasing number of nonprofit organizations started to carry the projects and be active. Estonian media became supportive to civil society efforts. Media outlets allowed more and more space for discussions and informed public about civil society activities. As a result of steady growth in numbers, capacity and sustainability Estonian NGO sector has reached the level of “consolidation” having successfully passed the early transition and mid-transition periods. According to 2004 NGO sustainability index Estonia scored 2.1 points in 7 point scale, where the highest points equal to early transition and low points indicate the consolidation (Chart 3.1). It means that the problems the third sector was facing in the yearly years of transition were successfully tackled by the time of EU accession. Society became less skeptical, more supportive and more involved.

Latvian and Lithuanian civil sector went through the similar way of development. The third sector was widely supported and one can even say “imported” from the west. At the beginning of transition period there were proportionally more organizations registered than the people involved in NGO activities. Public image of NGOs was much worse in Latvia and Lithuania than in Estonia. There were controversial opinions if they are “friends or foes”. That’s why the local contributions were low and the major source of income was foreign donations. Financial viability of NGO sector in Latvia and Lithuania lagged behind the Estonian indicators. In the late 1990s NGO sector experienced considerable revival. In Latvia NGO sustainability index decreased from 4.2 (1998) to 2.8 (2000) and Latvia also ended up on the level of “consolidation” (NGO sustainability Index 2004). But some sub indices of NGO development were not still alluring. For example the organizational capacity and financial viability indicators reached the threshold level - 3 point and turned out to be on the stage of mid-transition. Similarly, Lithuanian NGO sector showed the weakest points in financial viability, public image and service provision. In

2004 Lithuania was assumed to be on consolidation level as well, with the score of 2.7. The comparative indicators of the Baltic States' NGO sector development is given in the Chart 3.1.

Chart 3.1.



Source: NGO Sustainability Index reports <http://www.usaid.gov/>

To summarize the overall results of democratic transition we can have a look at the democracy score ratings offered by Nations in Transit (table 3.3).

Table 3.3 Democracy Score Ratings (7 point scale with 1 representing the highest and 7 the lowest level of democratic development)

<b>New Democracy Score (Aggregated Index)</b>							
	1997	1998	1999	2000	2002	2003	2004
Estonia	2.1	2.05	2.25	2.13	2	2	1.92
Latvia	2.15	2.25	2	2	2	2.25	2
Lithuania	2.15	1.95	2.29	2.21	2.21	2.13	2.13

Table 3.3 (I) Subindices 2004

	<b>Electoral process</b>	<b>Civil Society</b>	<b>Independent Media</b>	<b>Governance</b>	<b>Legislation</b>	<b>Corruption</b>
<b>Estonia</b>	1.5	2	1.5	2.25	1.75	2.
<b>Latvia</b>	1.75	2	1.5	2.25	2	3.5
<b>Lithuania</b>	1.75	1.5	1.75	2.5	1.75	3.5

Source: Nations in Transit 2004

To come to the conclusion, we can say that the Baltic States chose the right strategies for political transition. Even though the ways they took were not smooth and the progress was not easily achievable, still they succeed to reach the desirable level political development. Nation-building process had its painful side in terms of “transition victims” [Russian minorities] whose citizenship rights were sacrificed for the national security reasons. Defensive nationalism was the only optimal choice at least on the initial level of nation-building process. Even though harsh minority policy was in some aspect controversial to liberal democratic principles, the supreme interest in this case was neutralization of the explosive situation and prevention of ethnic cleavages in the future. The aim was achieved - the visible sign of ethnic tensions diminished and ethnic separatism was avoided (Park 1994). Estonia and Latvia never experienced the violent clashes based on ethnic issues.

On the next level of the nation-building process the Baltic States started to overcome the traditional ethnic nationalism through the legal reforms and attempts to make minorities as a legitimate part of the society (Lauristin, Heidmets, 2002). “Physiological drama of thousands of people” (Lauristin, Heidmets, 2002) gradually started to come to an end. State and society building was the matter of changing attitudes towards politics. It was gradually achieved by the beginning of new century. In spite of dilemmas, controversies and obstacles, the Baltic States passed the litmus test of European Union, NATO and other international institutions and got the pass for more integration in Western political culture.

## **Chapter IV**

### **Social Transition**

#### **4.1. Traditions and Changes**

The break-down of the Soviet Union produced a set of transitions in social sphere. Implementation of market economy principles brought fundamental and dramatic changes on this field. In paternalist Soviet state social services were universally and generously provided by the government, there was no space for individual initiatives. Efficiency and quality of soviet social services is another issue but the fact is that the break-down of the system brought the hard-times for transition societies. Urgent social issues that emerged after the system break-down, had to be dealt though social policy reforms.

It is worth to note that social issues were not in the top priority list of transition countries, particularly – the Baltic States. At initial level of transition the main priority was the building of economic and political institutions; it was widely believed that growing economy and stable political environment would automatically brought the solutions for social problems. This logic is quite accurate but the issue is not as simple as that. One can argue that people should first feel some ground under their feet in order to endure “the wind of changes”.

In the early transition period state still remained the main agent in providing social protection in Baltic States. It was expected to be so, because the environment for individual initiatives was not mature yet. However, compared to the soviet period, the role of the state diminished significantly.

Political background determined the choice of social policy model. Right-wing governments of the Baltic States opted for liberal model rather than comprehensive social-democratic one. Although the hard efforts of left-wing politicians to implement at least some elements of universal social security scheme such as family benefits, mandatory health and unemployment insurance succeeded, they were not backed with financial tools as far as the fiscal policy was in hands of right-wing parties. Later on, the impact of Europeanization and globalization influenced the situation so that the social issues started to be paid considerable attention. The best practices of Scandinavian countries have been adopted and shared by the Baltic States. Before reaching

the desired level of social security, they undergone the fundamental changes and faced the problems that had to be dealt urgently and efficiently.

I will focus on the two major field of social sphere: labor market development – un/employment as a challenging issue for potentially active working force and pension reforms - as a source of elderly protection.

## **4.2. Labor Market Developments**

Moving out from paternalistic system brought undesirable by-products of transition. The shift from central planning to market economy resulted in the sharp decline of labor demand. The choice of “shock therapy” transformation strategy was motivated by the hope that the positive results would be achieved in a short time-period, but at the beginning it was “a lot of shock but little therapy”. Thousands of people in the Baltic States got affected by the wave of unemployment. It was predictable and logical continuation of Soviet system break-down because it was “transition from a world of stable wages, stable labour demand and stable labour supply to a more dynamic and flexible system where market forces were allowed to operate; withdrawal of the policy of full employment, development of industries according to their economic efficiency rather than according to their ideological importance” (Saar, Unt 2006).

In Estonia the rate of unemployment reached almost 10 percent in 1995-1996 (chart 4.1) despite the fact that economy had already been growing. The problem was related to unqualified labour force; the gap between labour skills and modern job requirements. Many posts remained vacant due to the absence of specialists with proper knowledge and working skills. The quality of vocational education system was quite low; consequently ex-soviet labour force was not able to refresh their outdated skills and flexibly react to the market needs (Aidukaite, 2009).

Another problem was related Russian-speaking minorities with Estonian language barrier. Language knowledge became necessary precondition for acquiring the job after the independence. Besides, as Lauristin assumes, Russian minorities were less adaptable to market economy structure than native Estonians. The aspiration of “returning to the west” was extremely high among the titular nation while the new political and economic order was shocking and strange for Russians. Lauristin claims that minorities lagged behind the ethnic Estonians in terms of modern development. “Historically Estonia, as well as Latvia, being on the western edge of the Russian Empire, was more open to developments in Europe...The rapid capitalist

development and strong parliamentary system of the 1920s and early 1930s increased the pace of political and economical modernization in Estonia. At the same time, in the Soviet Union, a totalitarian regime turned Russia toward socialist industrialization and forced collectivization. The post-war immigrants in Estonia represented Soviet-type collectivism, including obedience to the party elite, denial of market relations, and paternalism and collectivism in work-place relations” (Lauristin, Heidmets, 2002). This situation resulted in over-representation of Russian minorities among the unemployed in Estonia.

Estonia suffered from regional disparities in unemployment. Big cities and business conglomerate areas were not as much affected by unemployment as rural areas. Regional disparities were caused by structural development of economy. Inflow of foreign investments and implementation of market economy resulted in the development of service sector, while agriculture, hunting, fishing, mining etc. were demoted on the secondary level. Former Soviet collective farm system demolished and the number of employed in agricultural sector decreased by 55.7% in 1996 as compared to 1992 ( Estonian Human Development Report, 1998). So the shock of altered economic conditions caused extra social problems in rural areas.

How could the problem be solved? In market economy system government is not the main provider of the jobs. What was their role and responsibility then? Estonian government introduced active labor policy in 1997. They provided the training and re-training programs for potential working force in order to improve their working skills and increase their eligibility for job vacancies. Also, government started giving subsidies to start small private business (Aidukaite, 2009).

Another way to alleviate the problem was the improvement of social protection system. During the first decade of transition period unemployment benefits were quite modest and amounted 8 per cent of average salary by the year of 1999 (Aidukaite, 2009). But later on, in 2003 Estonian government introduced more efficient and more generous mechanism of unemployment insurance. Unemployment benefits started to be financed not only from the state budget but from Unemployment Insurance Fund as well. State Budget started to provide security on the basis of proven needs only for those people who could not qualify for unemployment related insurance. At the same time the procedure of qualification for insurance has been simplified significantly. It only needs to have been at work at least six month during the last year. According to the new

rules a person can get almost half of his/her previous salary as an unemployment insurance benefit (Aidukaite, 2009).

Another solution for unemployment was “automatic stabilizers”. In the early transition period some people immigrated to the richer countries to find job there. It caused labor shortage in Estonia, therefore it helped to reduce unemployment. Also, market forces such as investment-driven economy and business-friendly environment contributed to the improvement of the un/employment situation. Increasing trend of employment could be observed in commerce and finance sectors. Employment growth in the 1992-1996 period showed 15.4% and 14.3% respectively (Estonian Human Development Report 1998). It should be mentioned that significant improvement of unemployment situation can be observed only after the accession in European Union. In the late 1990s when unemployment started to reduce as a result of speeding economy, suddenly the situation deteriorated again in 1998 because of Russian financial crisis. High unemployment indicators can be observed on the following years of the crisis, as an inertial development of the 1998 economic blow. So dealing with unemployment problem was quite time-consuming process, but Estonia still managed to tackle it as much as it was possible. Since 2001 unemployment indicator shows downward slope (chart 4.1).

Latvian labor market was hit by the same wave of changes. Industry sector got the most affected by the structural economic changes. As it was noted in the second chapter, Latvia was the most industrialized country among the Baltic States, so the share of industrial employment was high. The soviet system-collapse resulted in the sharp decline of industrial employment. The number of employed in industry sector has decreased by 41.6% in 1995 as compared to 1992, the same indicator for the building industry showed respectively 45.4% (Estonian Human Development Report, 1998). Decline of employment in agricultural sector was comparatively moderate compared to Estonia. As far as agriculture has never been the primary sector in Latvia, the employment share was low even in Soviet times. Consequently employment drop in the 1991-1995 period was only 11.3 %. Financial sector did not experience growth as it did in Estonia. Employment indicator even declined by 9.4 %. Out of total employed, 6.5% worked in this sector by 1996 (Estonian Human Development Report, 1998). The only sector which showed explicit increase in employment was energy with 54.5 % employment growth indicator.

Regional disparities in unemployment were also significant in Latvia – lowest unemployment level could be observed in urban areas: Riga, Ventspils, Tukums, Talsi and Liepaja districts. The most difficult situation was in the south-eastern part of the country which showed comparatively low level of development in Soviet times as well. According to the Human Development Report (1995) 29.1 % of unemployed lived in the cities and 70.9 – in rural areas (Latvian Human Development Report, 1995).

Unemployment rate shows sharp upward slope in 1996; while in early 1990s the rate is even lower than in Estonia. It can be explained by the fact that in Latvia rapid economic changes and large-scale privatization process started off with delay. Soon after the first wave of unemployment, Latvia was affected by Russian financial crisis and the downward-sloping rate of unemployment stagnated on the level of 14% during the three years (1998, 1999, 2000).

In order to deal with the problem, Latvian government introduced the active labor market policy. Considerable attention was paid to the improvement of high education level, quality of vocational schools and provision of trainings. Career Counseling Center, a net organization that was represented in several major cities of Latvia, provided the students and employment seekers with consultations on professional orientation and career choices.

Also, State Employment Service (SES) organization carried successful employment campaigns. It provided trainings for the unemployed, in order to make them eligible for the vacancies and then help them in finding the jobs. SES cooperated with employers in order to find out their requirements and make the trainees meet the criteria. In 1998 8000 people took the trainings, improved their skills and turned to potentially active labor.

State Employment Service established Job Seekers Clubs for the people who had not worked for a long time and lost aspiration and motivation to get any job in the future. This psychological assistance helped the unemployed to gain confidence and start seeking the job.

SES helped many employment seekers to find jobs. During the first eight months of 1998 8324 job seekers got employed with the help of State Employment Agency. It accounted 12% of the total number of the unemployed people registered in SES (Latvian Human Development Report 1998). We can say that SES was the main mediator promoting the dialogue between employers and employees. Similar to Estonia unemployment significantly declined during the following years of EU accession (Chart 4.1).

In Lithuania significant growth of unemployment started from 1995. Assessing the structural character of unemployment one can find more similarities to Latvian than to Estonian situation. The most affected economic sectors were industry and building. In the 1992-1996 period the number of people working in these sectors declined by 42.2% and 29.7% respectively. Financial sector did not experience any growth. It remained on the same level as 1992. Out of total employed, only 3.5% was working in financial sector by the year of 1996. Consequently Lithuanian as well as Latvian market was influenced by Estonian financial institutions and Vilnius and Riga stock exchanges were depended on Tallinn stock exchange (Estonian Human Development Report, 1998). This is a good example of Baltic regional cooperation as a guarantor of successful overcoming of the problems.

Different from Latvia and Estonia, agricultural sector experienced employment growth in Lithuania. With 10% employment growth during the first four years of transition agriculture became the largest economic sector. Out of total employed, 24.2% percent was working in agricultural sector in 1996 (Estonian Human Development Report, 1998). Due to the employment capacity most of the young people expressed willingness to choose the profession in agricultural fields. Along with agriculture, the service sector showed significant growth. It increased employment possibilities in urban areas. In 2000 more than half of the young people (55%) were employed in service sector (Lithuanian Human Development Report 2001) This is the reason why regional labor market disparities did not show as sharp contrast between rural and urban areas as it did in Latvia and Estonia. On the one hand, agricultural sector growth had positive impact on rural employment because it did not require high education and re-qualification of working force; but on the other hand it was negatively assessed in terms of EU membership. The reduction of agricultural sector was one of the preconditions of EU accession. Agricultural sector in developed countries is based on low employment but high efficiency that could not be said about Lithuania.

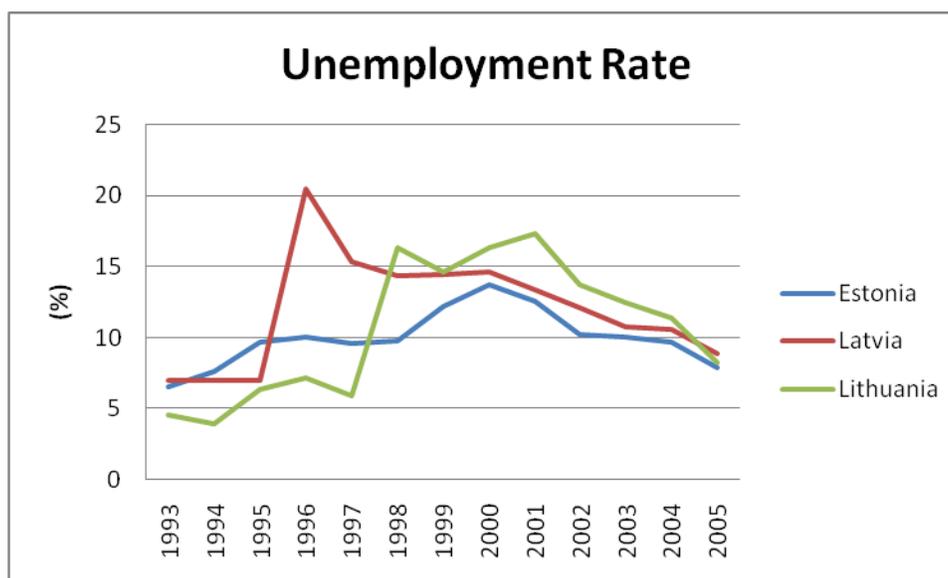
The government started to arrange the legal framework in order to heal the social pain of unemployment. The law on Unemployment Benefits was adopted in 1996. It defined the status of unemployed according to which the registration in Labor Exchange database was carried out. The eligibility of unemployment benefits was stricter in Lithuania compared to Estonia. One of the requirements was the two-year record of previous employment. The young could not meet

this requirement in many cases, because of the absence of 2-year work experience. This is the reason why only 29% of the young unemployed received unemployment benefits in 2000 (Lithuanian Human Development Report 2001). But I would assume that young people had more chances to get employed than those who lost jobs after the Soviet Union collapse. They are more motivated and aspired to acquire necessary qualification by getting high education, university degree or at least improve the working skills through vocational trainings. To say in other words, young people are more adaptable to the changes than the old. The limits of getting unemployment benefits are compensated by additional support for the young provided by Lithuanian legislation. In the frame of active labor market policy young people could participate in career planning programs providing the people with consultations and suggestions on professional orientation. (Lithuanian Human Development Report, 2002).

The law on unemployment benefits was amended in 2001 and streamlined the conditions of getting unemployment benefits for the old. People, who have only five years left till the pension age, were eligible for the additional support on the labor market (Lithuanian Human Development Report, 2002). This amendment was introduced for the aim of avoiding discrimination by age. Also, the 2001 amendment provided extra facilitation for those unemployed who had two years left before pension age. They could be entitled to unemployment benefits for the entire pre-pension period (Lithuanian Human Development Report, 2002).

One of the priorities in combating the unemployment problem has become education and lifelong learning “that combines seeking new knowledge with qualification and competitiveness in the national and international world labor markets” (Lithuanian Human Development Report 2002). The number of people with tertiary education almost doubled in the period 1996-2000. (ibid). Professional choices by students have changed. More and more people were studying low, information technology, and architecture – those fields that would be prosperous for their career. Engineering, agriculture, forestry and fishing became less demanded. (Lithuanian Human Development Report 2002). As a result of right social assessment and efficient government strategy, unemployment started to decrease in 2001.

Chart 4.1



Years	Estonia	Latvia	Lithuania
1993	6.5	6.951	4.565
1994	7.6	6.951	3.943
1995	9.7	6.951	6.355
1996	10	20.508	7.133
1997	9.6	15.379	5.9
1998	9.8	14.35	16.375
1999	12.2	14.473	14.6
2000	13.681	14.618	16.375
2001	12.575	13.346	17.362
2002	10.25	12.084	13.764
2003	10.025	10.74	12.419
2004	9.653	10.611	11.372
2005	7.914	8.82	8.271

Source: <http://www.indexmundi.com/>

One common trend is significant in combating unemployment in the Baltic States. The situation significantly improved after the EU accession. Mobility of labor, service, goods and capital among the EU countries contributed to the growth of employment. Also the regional disparities have narrowed down as a result of subsidizing poor regions by the EU structural funds. After EU accession labor markets in Baltic States have become more flexible and it helped the eradication of regional mismatch of workers.

### 4.3. Pension System Reforms

The Baltic States implemented multi-pillar pension schemes in the late 1990s. Un/employment rate considerably determines the effective functioning multi-pillar pension system as far as it is highly depended on current labour force contributions. In the long run unemployment can cause the decline of the average pension. This is one of the reasons why the new pension schemes were impossible to implement in the early years of transition when the unemployment was booming.

Latvia was one of the first reformers which made a shift to pay-as-you-go (PAYG) pension scheme in 1996. It was followed by the other Baltic “sisters”. A couple of years later all of them implemented three-pillar pension schemes which was propagated by the World Bank (Table 4.1)

Table 4.1 Three-pillar old-age pension systems and starting dates in the Baltic States

	I Pillar	II Pillar	III Pillar
Latvia	National defined contribution pay-as-you-go (NDC PAYG) pension scheme, launched in January 1, 1996	The state <b>mandatory</b> funded pension scheme, launched in July 1, 2001	Privately managed voluntary funded schemes, launched in July 1, 1998
Estonia	State-managed pay-as-you-go (PAYG) pension scheme, launched in April 1, 2000	Privately managed <b>mandatory</b> funded pension scheme, launched in July 1, 2002	Privately managed voluntary funded schemes, launched in August 1, 1998
Lithuania	State-managed pay-as-you-go (PAYG) pension scheme, launched in April 1, 2000	The state <b>mandatory</b> funded pension scheme, launched in January 1, 2004	Privately managed voluntary funded schemes, launched in January 1, 2000

Source: Tiiu Paas, Marit Hinnoaar, Jaan Masso, Orsolya Szirko “Social protection systems in the Baltic States”, Tartu 2004.

While analyzing the effectiveness of pension system, we should pay attention to the demographic trends. Negative demographic development can have deep effect on pension systems in terms of

financial sustainability. The current labour force would not afford the necessary supplement of pension funds if the number of the retired in increasing intensively.

The Baltic States faced the problem of depopulation and aging due to the “declining birth rate, high mortality among young men and children from accidents and diseases caused by stress, and loss of the more active part of the younger population, which has emigrated to the West in search of education and better paid jobs”( Lauristin, 2007).

Consequently the demographic picture of the Baltic States was not very favourable (table 4.2).

Table 4.2 Age structure of the Baltic States’ population in 2001 (% of population)

	0-14 years old	15-64 years old	64 years and over	Youth dependency ratio	Old-age dependency ratio	Dependency ratio
Latvia	17.0	67.6	15.4	25%	23%	48%
Estonia	17.6	67.2	15.3	26%	23%	49%
Lithuania	19.3	66.6	14.1	29%	21%	50%

Source: Tiiu Paas, Marit Hinnosaar, Jaan Masso, Orsolya Szirko “Social protection systems in the Baltic States “, Tartu 2004.

*Note* : The youth dependency ratio is the ratio of people aged under 15 to the population in the working age range; old-age dependency ratio is the ratio of people aged 64+ to the population in the working age range; the dependency ratio is the sum of the two.

Economic constraints and aging population put enormous pressure on the system designed to protect elderly in the Baltic States (Aidukaite, 2009). The Baltic States successfully implemented the multi-pillar pension system that was described above. The following pages will describe the ways that the Baltic States went through during the reforms.

#### **4.2 (i) Estonia**

Since regaining the independence, Estonian pension system went through the two major phases of transformation: First was the separation from the Soviet arrangement in 1990-1992 and the second entailed the move from single-pillar to multi – pillar model and supplemented the state system with privately managed pre-funded pension schemes in 1998-2002 (Leppik, Võrk 2006).

In 1998 Estonia adopted the State Pension Insurance Act and Pension Funds Act that enacted the crucial changes in the system.

The main part of the reform was the implementation of particular rules under separate pillars.

The first pillar became compulsory, non funded scheme, based on current contributions or taxes. “The first pillar bears the main burden of old-age payments in Estonia: it encompasses the largest proportion of retirees and is the most heavily financed.” (Aidukaite 2009). The rate of social taxes is 33% of gross wage out of which 20% is transferred to pension insurance budget and 13% - to the health insurance budget.

The qualifying criteria of employment related pension includes the following conditions: the retirement age, the length of insurance period under the pension scheme (minimum requirement is 15 years), social insurance contribution period and amount.

The new legislation has changed the formula of old-age pension. If it was calculated on the bases of length-of-service, after the reform the calculation was made according to the social tax paid over the full career. (The flat-rate based element remained the same). The dividing line of pension service experiences was set on the year of 1999. For the people who withdrew from work before 1999, the pension is calculated according to flat-rate based amount and the number of service years; for those who entered the labour market in 1999 or later, the state pension will consist flat-rate based amount and insurance contributions; and the transition generation, those who worked before and after 1999 is the target of three-part pension formula including the length-of-service element combined with the two others mentioned above.

Very important change under the first pillar was the introduction of indexation. It transformed the first pillar into a defined-benefit pension scheme. Increase of pensions is not the matter of ad hoc political decision any more. Benefits are now adjusted based on a formula in the law. “This new index, which gives equal weight to price increases and increases in social tax revenues, determines changes over time in individual pensions and the state’s total pension obligations” (Leppik, Võrk, 2006) .

The first pillar is also the funding source of disability pensions. During the reforms it was replaced by so-called work incapacity pensions. In 2001 disabled people were expanded to include disabled child allowance, disabled parents allowance, education allowance, disabled

adult allowance, caregivers allowance, rehabilitation allowance, in-service training allowance (Aidukaite, 2009).

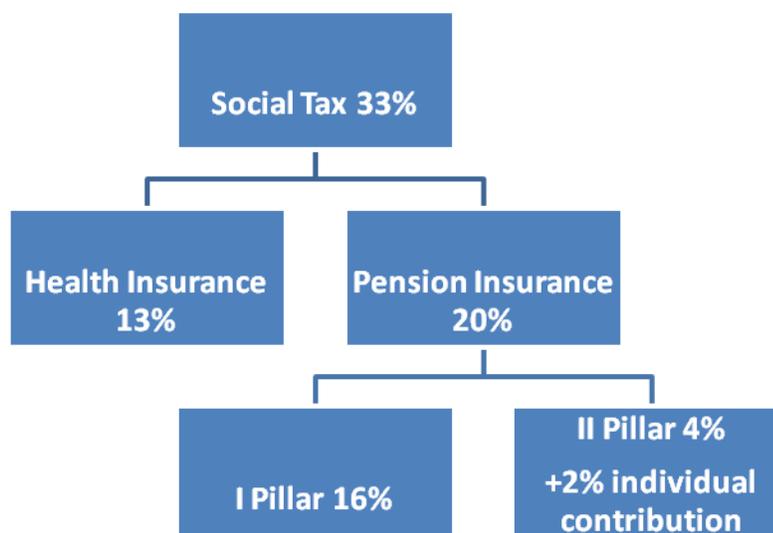
The main discussion was connected with the implementation of the second pillar. It is private co-insurance branch of pension system, funded by individuals and state supplementations taken from social tax.

IMF and World Bank propagated the compulsory participation in the second pillar. Some of the post communist countries (Czech Republic for example) resisted the pressure of international institutions and maintained the voluntary private pension insurance, while Estonia opted for compulsory private pension insurance at least for new entrants to the labour force starting in 2002; for those who had already been working before 2002, participation in the second pillar has been set to be voluntary.

The second pillar addresses the risk of old age only and does not provide disability pensions.

The participants of the second pillar are legally obliged to pay 2 percent of wages as an additional contribution. The choice of the fund is free. The whole system works according the following formula: 16+4+2. It means that individual contributions - 2% of their wage - is supplemented by the state with 4 percentage points transferred from the first pillar pension insurance (20% of social tax). Consequently, after the participation of private co-insurance system only 16 % of social tax goes to the first pillar (instead of 20%). (Chart 4.2)

Chart 4.2.



Source: International labour Office

In spite of the money transfer from the first pillar, the amount of state pension is not reduced and the minimum pension level, which was introduced during the first pillar reform, is still maintained.

As regards the third pillar, it was introduced earlier than the second and is completely voluntary. It provides additional savings and insurances.

In general sense, Estonian pension system is employment-related but for those who are not eligible for employment-related benefits, the system provides with flat-rate pension. It is not depended on contributions and is financed from general tax revenues. The accessibility of flat-rate pensions is guaranteed by citizenship or residency.

As regards the retirement age, along with the increase of pensionable age to 63 for men and to 60.5 for women, the new legislation provided the possibility of early retirement – up to three years before normal retirement age. The cost of early retirement was set in form of benefit reduction by 0.4 percent per each month. As a counterbalance of this option, the new legislation increased the pension for postponed retirement by 0.9 percent per month. (This rule was enacted in January 1, 2001) “Continuation of work yields a double benefit, as the full career is taken into

account for calculation of the pension and the additional working years also increase the pension amount.” (Leppik, Võrk, 2006)

In spite of these challenges of the pension system, empirical research shows that the pensioners are not the poorest part of Estonian society. Due to the indexation they are more or less protected from dropping under the poverty line.

#### **4.3 (ii) Latvia**

In the early 1990s Latvia experienced dramatic deterioration of economic and demographic conditions. Due to the low fertility rate, low life expectancy and intensive emigration, Latvian population dropped by 13% in 1990-2004 time-intervals. Economic situation was even worse than in Estonia. Raising unemployment and increasing number of retirees created an urgent necessity of pension reforms.

The first attempt was made in 1991 when the government adopted the laws on State Pension and Social Tax. According to the new legislation the social security system was financed by employer and employee contributions, not from the state budget any more. Social tax rate was set to be 38% of gross wage. Soon after the changes it became clear that the country was not able to afford this system. “The financial balance of the newly adopted pension system was upset by the liberalization of prices and the skyrocketing inflation that followed on its heels, and the situation was worsened by an increase in the number of retirees” (Vanovska, 2006)

The further step of the government was the negotiation with the World Bank for a loan to set up Welfare Reform Project in 1993. The World Bank then asked the Swedish government for an assistance in developing new pension system in Latvia. The Swedish Social Insurance Board (SSIB) got involved in the project. The Latvian government bodies (The Ministry of Welfare and Minister of Social Affairs for instance) also participated in preparation of Social Welfare Concept but the whole reform was the “product” of international actors.

The first proposal of the Concept was based on four-pillar system. The first and the third pillars were basically similar to Estonian model that was described above. As regards the second pillar, in Latvian model the participation requirements were set according to the age. For the people below the age of 30 at the time of its introduction (2001) the participation was compulsory, for

30-49 age groups, it was voluntary but those 50 and over could not participate at all. Their investment period was too short to ensure replacement rate.

The fourth pillar was introduced for those people, who had already retired or were about to retire and did not participate in the second pillar. The aim was the provision of additional pension income for them. It was intended to be financed from state budget. Later on, with the recommendations of Swedish experts, the idea of the fourth pillar was rejected and not pursued further.

The change in social tax rate and its redistribution burden went through several steps of reformation. As it was mentioned above, the total social insurance contribution rate was quite high (38%) from the very beginning. The government made the legislative changes in the Law on Social Tax that was aimed at: 1) reduction of the overall social tax rate 2) equal distribution of tax burden among employers and employees. Before 1995 almost the whole tax burden was born by employers (37% out of 38%). Increase of employee's responsibility became a big deal after the legislative changes.

The first goal was achieved in 2003 when social insurance contribution actually decreased to 33%, but the employers' share was not increased as much as it was called for in the law.

Different from Estonian situation, the pension contribution rate is not fixed in Latvia. The reform set the rate of 20% (out of 33% social tax), but actually it is higher due to the transitional costs. The rate changes every year. In 1998 it was 27.37 percent, in 1999 it was 27.91%; in 2000 it was 27.10%; in 2001 it was 26.93%; in 2002 it was 27.10%; in 2003 it was 25.59%; in 2004 it was 25.51%; in 2005 it was 25.26%. (Vanovska, 2006). This is the reason why the indicator of Latvian total pension expenditures is higher in Estonian and Lithuanian (Chart 4.2).

Latvian second pillar differs from Estonian in several aspects. It does not work with the same principle (16+4+2). The portion of the contribution that is transferred from the first pillar, had initially been higher than Estonian and consisted 5 or 6 percent out of suggested 20% pension insurance, since 1999 it even doubled and raised to the half of pension insurance rate that might be 10% or even more.

At initial stage, the reform introduced early retirement possibility up to 5 years before the normal retirement age for which people needed to have at least 10 years insurance record. The benefit reduction was 6% for every year (a bit higher than in Estonia—4, 8%). Actually many people took

this option. The problem was the low public awareness of the new system; many of early retirees could not even calculate how low their benefit would be. Normal retirement age was set to be 60 years for both men and women.

In 1999 the “balance of social insurance budget deteriorates sharply” (Vanovska, 2006). The reasons were: “combination of the concession to working pensioners, the extra indexation in 1998, and the Russian financial crisis” (Vanovska, 2006). In order to tackle this problem, the government increased the retirement age to 62 years of age for both men and women. They also intended to abolish the early retirement but the opposition strictly resisted this decision. The compromise was reached: the early retirement was maintained for the men beginning at age 60; benefit reduction rate increased incredibly – to 20% during the period till the individual reached the retirement age (Vanovska, 2006). In 2002 some exceptions were set for early retirement. Those people who had 5 or more children or a disabled child, and possessed at least 30 years insurance record were entitled to early retirement up to five years earlier than statutory minimum.

#### **4.3 (iii) Lithuania**

Lithuania was the last Baltic country which made a full shift to multi-pillar pension system. The implementation of the second pillar finished in 2003, even though the changes in the pension system took start from the very beginning of the independence period.

Similar to the other Baltic and post communist states, Lithuania experienced economic and demographic problems due to the population loss and breakdown of centrally planned economy. The country has faced the emergency of legal and institutional changes.

The final form of the pension systems has started to take shape since 1995. The initial stage of the reform was mainly focused on the implementation of pay-as-you-go system complied with legislative arrangements. The crucial elements of the reform were: change in pension formula, increase of retirement age, setting of minimal insurance period for partial and full pension, indexation, and implementation of dual and social pensions.

The old-aged pension formula included earning-related (10 best years of 15 previous wages and all the years after 1994) and flat rate components (0.5% of monthly wages for each year of the

insurance period). The flat-rate amount was set by the government in accordance with Minimum Substantial Level (MSL). It could not be lower than 110 percent of Minimum Substantial level.

The disability pension schemes were also revised under the first pillar reform. Depending on the working capabilities, there were 3 groups distinguished: First group included those people without working capacity and depending on nursing, second group was comprised by the people with serious disabilities and the third group included those who were considered to have relatively limited working capabilities. Disability pensions were calculated with the same formula as old-aged pensions (Lazutka, 2006).

Important elements of the first pillar were also the introduction of state and social pensions. State pension was given to the victims of the World War II and the Soviet regime; military personnel; academics and honoured people (might be artists, writers, patriots, mothers of 10 or more children).

Social pension recipients are: mothers with 5 or more children and persons caring for disabled family member for a long time.

The new pension system offered the possibility to receive more than one pension. This was the basic idea of dual pensions – retirement social insurance pension was paid with widows' and state pensions.

This bunch of reforms became the source of quite serious economic and social challenges in Lithuania. The Social Insurance Funds budget deficit was one of the most vulnerable problems that the Social Insurance Board faced that time. The causing factor of the deficit was that “the pension scheme was financed at the expense of short-term social insurance benefits. In addition, there were certain seasonal fluctuations that were not reflected in the social insurance year-end budget data...Since the Social Insurance Fund had no reserves, these seasonal fluctuations created cash flow problems.” (Lazutka, 2006)

In 1999 International Monetary Fund suggested to increase the social contribution rate on order to deal with the problem. The strategy was accepted by the government and in 2002 the Social Insurance Fund budget has already created surplus.

Table 4.3 Social Insurance Fund budget surplus / deficit (%) of GDP

1995	1996	1997	1998	1999	2000	2001	2001	2002
0.0	-0.1	-0.1	-0.1	-0.8	-0.3	-0.1	0.2	0.2

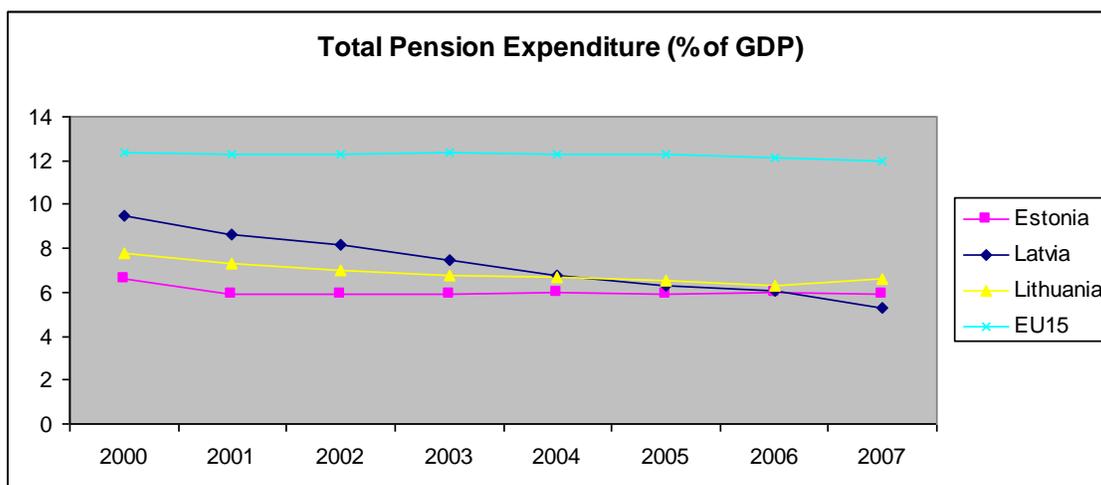
Source: International Labour Office

Another flow of reforms that gave the final shape to current pension system took place in 2003-2004. On this stage the National Pension scheme was partially privatised. The fully funded pension schemes were established. It significantly improved the conditions of self-employed people who preferred to avoid high insurance contributions and consequently received low benefits from the system. The private fully funded element became the supplementary part of the solely functional pay-as-you-go system. Existence of informal markets accompanied with unfavourable changes in labour market and demography was making it less and less effective.

Participation in the second pillar is optional in Lithuania. Similar to the Latvian model, the age is the determinant of compulsory or voluntary participation in the second pillar (mandatory only for persons under age 40, voluntary for persons between 40-50 years of age). The contribution rate is 5% percent for the second pillar while the total pension contribution rate is Lithuania is 25% (which is more close to Latvian indicator). The main objective of multi-pillar pension system was to make more and more people involved in social insurance pension scheme. It has been working effectively as far as the number of insured people is expanding.

Even though the pension reforms were based on the same scenario that was propagated by the World Bank and IMF, the Baltic States' pension schemes are less generous than other European countries'. The share of pensions in GDP is less than EU average. In 2003 when the pension reforms were already finished in the Baltic States, Estonia spent only 5.9% of GDP on pensions; corresponding indicators were 7.5% for Latvia and 6.8% for Lithuania while the average EU15 pension expenditures was 12.3%. (chart 4 2).

Chart 4.2



Source: Eurostat

To summarize the results of social transition we can say that social reforms brought the consequences that were quite difficult to bear for many people. But majority of the population was still ready to make sacrifices for common goals. As Lauristin says “even if protests were voiced ...from the pensioners and farmers who were deprived of their substance means they were not heard. Government and politicians spoke with these groups in the voice of international authorities and “higher” national interests” (Lauristin, Vihalemm 2009). So the transformation was not velvet and painless but the common will of the government and endurance of the people led the Baltic States to the final success.

## Chapter V

### 5.1 Cultural Trauma of Social Change

The change of the political regime resulted in emergence of transition culture<sup>7</sup> in post communist states. The main component of transition culture is a set of understandings about the drawbacks of dictatorship and the final destination of the democratic path.

Kennedy defines Transition culture as “a mobilizing culture organized around certain logical and normative oppositions, valuations of expertise, and interpretations of history that provides a basic framework through which actors undertake strategic actions to realize their needs and wishes” (Kennedy, 2002). According to the same author, transition culture itself was built upon a global liberalism constituted in opposition to socialism. Kennedy assumes that transition is not an abrupt action, but a whole process animated by a particular culture of values. All countries that are engaged in this process realize the importance of global transformation, although the level of their openness to globalization is different. Some of them are open to the world, while the others remain restricted. And the values of the people living in the post-communist societies also split in two categories and become extremely incompatible.

Transition culture is oriented to individualism but some people still support the idea of collectivism, thus they are loyal to the previous regime. For example, one of the main values of the soviet system was solidarity in poverty and egalitarian justice; in contrast, the new transition culture is soaked with the idea based on competition principles and meritocratic justice. The value of security is replaced by the value of risk and chance-taking. Tendencies to social support are ignored and self-reliance is headlined instead.

It is widely accepted idea that social change produces trauma. “The concept of trauma as applied to society begins with the realization that change itself, irrespective of the domain it touches, the groups it affects, and even irrespective of its content, may have adverse effects, bring shocks and wounds to the social and cultural tissue” (Sztompka 2004). The process usually goes through the several stages: sudden, comprehensive, unexpected and deep change; disorganization of culture; traumatic conditions expressed by traumatic symptoms; posttraumatic adaptations and finally, overcoming trauma.

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<sup>7</sup> In this case, the notion of culture includes the whole meaning of social life

Jeffrey Alexander defines trauma process as a gap between the event and representation. He focuses on the disparities between the events on the one hand, and the representations of these events – on the other. Representation can be considered as a claim about the shape of social reality. According to Alexander, the cultural construction of trauma begins with such a claim made by the so called “carrier groups” - the collective agents for the trauma process. The “claims” are usually about unavoidable and painful social processes. Experiencing the trauma is a purely sociological process. The whole chain of the processes can be defined as a “traumatic sequence”. Piotr Sztompka distinguishes six stages of this traumatic sequence:

1. First is the traumatic change itself that includes four typical elements – it should be sudden, comprehensive, deep and unexpected.
2. disorganization of culture and accompanying cultural disorientation
3. traumatizing events affecting the life-world of the people
4. traumatic condition, expressed by a set of traumatic symptoms
5. posttraumatic adaptation and the ways of coping with trauma
6. overcoming trauma

By characterizing some of these stages from the collapse of communism viewpoint we could see more clearly the typical traumatic sequence as a whole. The collapse can be regarded as a traumatic change without any doubt. The typical elements are also presented – the change was definitely sudden and unexpected. It embraced every aspect of existence, from political to everyday life. Despite the traumatic effect on societies this change is considered as a positive change by the majority of the population.

As for disorganization of culture there can be distinguished two incompatible attitudes among the people. First, the pro-soviet attitudes shaped under the influence of the old communist regime and second, the seeds of a completely different culture, functionally demanded by the new democratic and capitalist institutions. For some people, the clash of the two incompatible cultures turned out to be dramatic as far as “their internalized, trained ways of life lost effectiveness and even became counterproductive or negatively sanctioned in the new system, while the new cultural rules appeared to them as alien, imposed, and coercive” (Sztompka, 2004). The degree of preparedness for democracy varied across the post communist countries. The penetration of western culture differed by the scope of intensity depending on the rigidity of

cultural gates raised by the local authorities. In case of the Baltic States the impact of alternative cultural complexes was quite strong. It exerted a salutary influence against the cultural shock of communist regime collapse.

As including parts of traumatic sequence, Piotr Sztompka emphasizes the five symptoms of trauma. First is the *distrust syndrome*; distrust towards governmental institutions, media, or public service. People tend to not trust the information given by the government; they believe that if anything goes wrong in society the politicians and bureaucrats are guilty. Apart from that, the interpersonal trust in everyday life is also shattered. Another syndrome is the *vague picture of the future*. People are pessimistic about the future and believe that the situation is gradually deteriorating. Consequently there appears *a nostalgic image of the past* which is another symptom of trauma. This nostalgia is not groundless. People start to compare the present socioeconomic situation with the past. The transitional period does not give glorious picture in this sense that is why people felt more satisfied under socialism. *Political apathy* is also one of the typical symptoms of the trauma. Even though it is easier to take advantage on political opportunities, people do not try to do it. Electoral absenteeism is high. And the fifth symptom is so called *post communist hangover* which means the reevaluation of the communist past. This symptom is a quite clear indicator of the polarized public opinion – for and against communist system.

The crucial element of the process is that people are not indifferent during the period of traumatic changes. They draw out the strategies how to cope with trauma. Piotr Sztompka assumes that there are four ways how people can respond to trauma. These ways are typical treatment of anomie as well, originally offered by Robert Merton: 1) innovation 2) retreat 3) ritualism 4) rebellion

With innovative strategies people try to take the systemic change as given and “make attempts at creative reshaping of their personal situation within the system in order to alleviate trauma” (Sztompka, 2004). Accumulating economic capital and raising the social capital are the expressions of this innovative strategy. Another element of the innovative strategy is an educational boom. The number of students nearly doubled in the post communist space; also the priorities in choosing a profession have changed significantly. The faculties students started to

choose were completely different from the ones they had been choosing before. As it was observed above, this tendency was quite typical for the Baltic States.

Apart from the innovative strategy, there is a retreatist adaptation as well. It means an escape from trauma “with a wait-and see orientation”. People with retreatist strategy blame the system for everything, complain about the living conditions and try to avoid the civic responsibilities.

The third type of adaptive responses is ritualism. In the frames of this response people “turn to the established routines and cultivate them as safe hideouts to deflect cultural trauma” (Sztompka 2004).

The fourth strategy is quite radical and organic. According to it, attacking the foundations of the system is the way to alleviate traumas. This adaptive response is called rebellion and it includes the most radical forms of the contesting orientations. Sometimes, this kind of response may be accompanied by the anarchic ideas as well.

After finding some ways of coping with traumatic change, the phase of overcoming process begins. Piotr Sztompka claims that post-communist trauma entered the healing phase rather quickly. In the Baltic States negative trends and traumatic symptoms started to disappear in the 1990s .

Theoretically overcoming the trauma is observed in three directions: 1) when traumatizing situations lose their salience, 2) coping strategies have real healing effects and 3) split between incompatible attitudes such as socialistic bloc culture and emerging capitalistic culture is no longer acute.

Sztompka assumes that important indicator for overcoming process was the successful multiple turnover of power through elections proving that the mechanism of parliamentary democracy actually operates. In this sense the Baltic States experienced substantial progress. Public administration, media organizations, third sector organizations started to contribute to this process and help the emergence of civil society.

In case of the Baltic States, trauma was overcome because of full mobilization of people and the popular support of democratic and market economy reforms. We can say that it was a “trauma of victory” (Sztompka 2004). Even the Russian-speaking minorities who had the strong sense of nostalgia towards the Soviet times started to accept the norms of modern capitalist society and consider themselves as internal part of the new system. It is assumed that the cultural trauma of

social change did not leave a deep scar on the societies of the Baltic States; therefore it started to disappear soon. Rebellion or retreat was not characteristic for the Balts. The optimism and clear strategy of the future developments made them respond with innovative strategies which finally led to the quick overcoming of the trauma.

## **Conclusion**

It is assumed that transition in the Baltic States was successful. How did they manage to be the best performers in the post-soviet space? They took the right path of modernization leading them to the European family. The “return” was institutionalised in 2004.

The Baltic States built economic, political and social systems from the scratch. Soviet leftovers were eliminated substantially.

Radical economic reform program so-called “shock therapy” turned out to be the best appropriate option for achieving economic growth. It was believed that rapid, comprehensive and fundamental economic reforms would bring the positive results in short time-period. Full-scale privatization, trade liberalization, inflow of foreign direct investments and stable macroeconomic environment were the necessary preconditions of the strategy. The Baltic States accepted the challenges of shock therapy and endured the pain of the initial “shock”.

Estonia was the most courageous and ambitious in this sense. It became the “flagman” and the role model for the other “Baltic sisters”. It inherited comparatively advantageous situation on expense of low industrialization level on the one hand and geographic and cultural proximity to the Scandinavian countries – on the other hand. Estonia managed to create business-friendly environment and started to become the recipient of foreign direct investments, coming from the Scandinavian countries majorly. It also shared the practice of “clean hands” from Finland, which is the least corrupted country in the world. Latvia and Lithuania were following the suit in the framework of strong Baltic regional cooperation.

The obstacles of political transition were overcome by the support of the international institutions. In terms of nation-building process, Estonia and Latvia managed to meet the democratic principles though implementing the prudent minority policies, recommended by the international organizations. The very fact that the Baltic States never experienced violent ethnic clashes can be perceived as one of the biggest achievements of the nation-building process.

In terms of state building, the Baltic States tried to evaporate the imprints of the soviet legacy. The establishment of democratic institutions with appropriate party system turned to be time-consuming process, but it was finally achieved in the end of 1990s through the expense of civil society activism. It is assumed that the Baltic States managed to reach the sufficient level of democratic consolidation by the beginning of the new millennium

Transition processes were socially costly for the Baltic States. It created “winners” and “losers” in the society. The young were affected by the changes in labor market, while the old turned out to be “losers” because of inefficient pension systems.

The structural nature of unemployment, unqualified labor force and regional disparities were the problems that needed to be dealt urgently. The Baltic States managed to achieve the progress in this matter by implementing active labor market policies. The economic growth was another cure for the unemployment problem.

One can find a strong correlation between unemployment and efficiency of pension systems. The latter is depended of active labor force contributions. The Baltic States launched the multi-pillar pension systems in the late 1990s after the unemployment situation started to improve. They adopted three-pillar pension schemes based on pay-as-you-go principle. This scheme was promoted by international institutions as far as it was assumed to be more efficient. The introduction of individual contributions was very important aspect of pension reforms. It has to be mentioned that, despite the rectification of pension systems, the Baltic States are less generous than the other EU countries in terms of government expenditures on pension schemes.

Even though the transition reforms were widely supported by the majority of the Baltic populations they still have traumatic affect on the public. It is called cultural trauma of social change. Important aspect of the phenomena is that people usually respond with different strategies in order to cope with the trauma. The final stage is overcoming the trauma which is assumed to be finished in the Baltic States. Being part of the European Union the citizens of the Baltic States do not have nostalgia to the soviet times. The final destination has been reached. Common internal will, external support and the ability to endure the transition problems defined the success of the Baltic transition.

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