By law and by custom: Factors affecting small and medium-sized enterprises during the transition in Lithuania

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Introduction

The transition process in the post socialist countries of Central and Eastern Europe and the former Soviet Union can be simply defined in economic terms as the process of the replacement of a centrally planned economy by a market economy. However it necessitates much more than that. Transition brings about fundamental changes to the entire social, political and cultural system. It is this process that awakened my interest in the transition process in general and specifically in Lithuania.

Arguably the greatest initial external influence on the transition process has been the policies prescribed by the Bretton Woods institutions (the International Monetary Fund and the World Bank) and the idea underlying them, the so-called ‘Washington Consensus’ (Kolodko 2001). Early on in the transition process, these policies focused on privatization, stabilization and liberalization of the macroeconomic situation. Though macroeconomic stabilization was of paramount importance, the rapid privatization and liberalization policies and the resulting neglect of developing a suitable institutional environment resulted in enormous economic contraction in transition countries. In Lithuania, the economic decline was more severe than that experienced in the US during the Great Depression (World Bank 1996).

In order to understand why certain transition policies were emphasized above others, it is important to understand the historical context. When the communist regimes of Eastern Europe and the Soviet Union collapsed in 1989-1991, neo-liberalism was the dominant paradigm in North America and Western Europe. As a result the emphasis in policy advice was heavily weighted towards the swift liberalization of domestic prices, international trade, and privatization (UNECE 2001:49). There was great optimism within the neo-classical school that institutional and other impediments to the reallocation of resources would not prove a serious obstacle to investment and sustained growth as long as ‘prices were right’ and a laissez-faire approach to private enterprise was taken. Institutional development could therefore be postponed and market forces could induce an instantaneous adjustment ‘without reference to the past’ (Ibrahim & Vaughan 2002).
The neglect of institutions proved to be an unwise strategy. As Kolodko correctly observes: *Liberalization and privatization unsupported by well-organized market structures, generated not sustained growth but a lengthy period of contraction. This was not an inherited problem, it was a result of poor policy* (2001:124).

In addition, though there was much interest in the privatization of state-owned enterprises (SOEs), considerably less interest was being paid towards the development of small and medium-sized enterprises (SMEs) in most transition countries. This struck me as a strange orientation. It contradicted the generally accepted view in many western developed countries that SME development is a key to economic growth, innovations and market competition (Acs & Audretsch 1990; Acs 1998; Acs & Audretsch 2001).

Ironically, while new evidence from mature western countries accumulated indicating the critical role played by SMEs in economic development, little if any attention was being paid to the SME sector in Lithuania. It was surprising that such an essential area of economic development was being overlooked. However, the neglect of the SME sector in the initial transition period can be traced to the general neglect of entrepreneurship and SME development within mainstream economics:

*Entrepreneurship and the population of small firms are treated as issues virtually separate from mainstream economic development. Entrepreneurs are the ghosts of economics unless their firms grow large and influential, their origins amongst a mass of other small start-ups forgotten* (Sweeney 1997:126).

However, it seemed to me that in Lithuania, as in other countries undergoing economic transition, the role of SMEs is socially and economically important. Not only are SMEs important for the role they play in sustaining the ideology of the free market, SMEs are also a crucial source of innovative potential and job creation possibilities (Johnson & Loveman 1995; Smallbone & Piasecki 1995; Benini 1997; Marot 1997; Scase 2000; Bartlett 2001). Lithuania, just as many other transition countries, continues to wrestle with persistently high unemployment rates even after being on the 'transition' path for
over a decade. A strong SME sector in Lithuania could provide further employment opportunities and contribute to economic growth and the development of a competitive market system.

The main aim of this thesis is to further investigate the development of entrepreneurship and SMEs in Lithuania. In order to achieve this, the following research questions are addressed:

- What are the specific characteristics of entrepreneurship in a transition setting?
- What barriers affect the development of SMEs in Lithuania?
- What differences between SME owners affect business performance?

The answers to these questions imply an answer to the underlying composite question: What factors affect the development of SMEs during the transition in Lithuania?

The potential influences on SME development in Lithuania are derived from theory, existing empirical evidence and intuition. An institutional theoretical approach seemed most suited for this thesis since it acknowledges the direct link between individual attitudes and perceptions and their effect on economic performance. The data collected by the author specifically for this thesis is mainly based on the perception and attitudes of SME owners and related officials in Lithuania.

In addition, this thesis analyzes the factors affecting SME development in Lithuania focusing on the institutional processes (historical, political, social, economic and cultural) that have contributed to shaping Lithuania's transition process. This thesis is a journey in which the past and the present meet to illuminate the current situation in the hope of positively influencing the future.
An institutional approach which takes into consideration the economic and social influence of both formal (laws, regulations) and informal (customs, culture) rules and constraints was a rather novel approach for analyzing the transition process when I began my PhD research at the end of 1998. By the late 1990s, international organizations such as the European Bank for Reconstruction and Development acknowledged the importance of institutions in its 1997 transition report, and stressed the necessity of strengthening existing institutions in order to yield sustained improvements in the regional investment climate. Four years later, the World Bank addressed the importance of institutional development in its 2002 annual report entitled: *Building Institutions for Markets*. Hence the approach taken in this thesis is no longer as novel as when the research was initiated.

**Limitations and scope**

The analysis in this thesis is limited to existing SMEs in Lithuania. Since my study uses Lithuanian data, I choose to use the official Lithuanian definition of SMEs as my guideline (further discussed in chapter 3). Many important issues such as the factors affecting business start-ups or bankruptcy are beyond the scope of my research. Due to data limitations, my analysis does not include longitudinal information.

In this thesis, the analysis of transition economies is limited to the countries undergoing a switch from a centrally planned economy to a market-oriented economy in Central and Eastern Europe (CEE) and the former Soviet Union (FSU).

**Outline of Research**

In this thesis the perceptions and attitudes with regards to factors affecting existing SMEs in Lithuania are presented and analyzed. Attitudes and perceptions i.e. the ideologies regarding SMEs matter because they can have a direct effect on economic performance (North 1997:3). In order to explore this issue, my research is structured as shown in figure ln-1. Lithuania’s current transitional situation is best understood within its unique historical context. Therefore in Chapter 1, I begin by providing a summary of the main historical, political and economic developments that have shaped the current situation in Lithuania.
Institutional theory forms the theoretical backbone of this thesis. In Chapter 2, the main conceptual elements of institutional theory are presented and are linked to the transitional environment in Lithuania. Gender is another important concept for this thesis. In section 2.3 gender is presented as related to economic research, institutional theory and to the economic and social position of men and women in Lithuania.

The main contributors within economics to entrepreneurship research are presented in section 2.4. Based on existing literature, a working definition and a model for productive entrepreneurship is developed for the transition country context. Further, a literature review is presented that highlights some of the distinctive characteristics of entrepreneurship in CEE and the FSU countries with a special emphasis on Lithuania.

The methodology used for the fieldwork conducted in Lithuania is presented in Chapter 3. A detailed description of the motivations, set-up, characteristics and limitations of the Litsme survey of SME owners is provided. In addition, qualitative data in the form of semi-structured interviews was collected amongst open-air market traders, SME owners, government officials and non-governmental organization representatives. The motivation for using a qualitative approach, to supplement the quantitative approach and the methodology used as well as data characteristics are also presented.
Figure In-1. Outline of the Research

Chapter 1: Introduction
Lithuania

Chapter 2: Theory
Institutional theory – Gender – Entrepreneurship

Chapter 3: Fieldwork and Methodology

Qualitative approach

Chapter 4: Open-air market traders
• path dependence

Quantitative approach

Chapter 5: Interviews with SME owners and officials
• residual communism

Chapter 6: Barriers to SME development
• interrelation of barriers

Chapter 7: Gender and SME development
• gender

Chapter 8: Theoretical Implications

Chapter 9: Policy Recommendations
Chapter 4 focuses on a form of ‘entrepreneurship’ that has survived both Soviet rule and the transition process namely trading at open-air markets (OAMs). After the collapse of the Soviet Union, it was widely believed that price and trade liberalization along with privatization would eliminate the distorted marginal markets tolerated under central planning and would hence result in the disappearance of the informal sector of the economy. However due in part to path dependence and the unique characteristics of the transitional context, OAMs have not only survived but in many cases thrive within the new market-oriented economy. In Chapter 4, I present a detailed investigation into this microform of entrepreneurship (i.e. license-holding traders) taking place at Gariunai, the largest open-air market in the Baltics. I discuss whether these individuals can be considered productive entrepreneurs using the definition I develop in Chapter 2 and investigate the social and economic role that OAM traders play in post-Soviet Lithuania. In addition, the specific barriers that traders encounter are presented and discussed.

There have been few, if any, studies which present the perspectives of SME owners in transition countries and the perspectives of governmental officials, non-governmental organization (NGO) representatives and related actors. In chapter 5, I allow the individual ‘voices’ of SME owners, governmental and NGO representatives related to SME development to be heard. The viewpoints of the interviewees are presented in order to identify the main barriers to SME legitimacy in Lithuania. The four main barriers can be categorized as Soviet mentality, lack of SME recognition, lack of transparency and lack of cooperation. All four barriers seem to have been adversely affected by ‘residual communism’ in the form of outdated attitudes, values, practices and norms that conflict with the principles of the free market-oriented economy.

Chapter 6 focuses on identifying the interrelated effects of four business barrier groups (formal, informal, environmental and skill barriers) on existing SME operations. In my analysis, I extend Douglass North’s original classification of formal and informal barriers to include environmental and skill barriers. Four barrier cluster variables are formed using hierarchical clustering. I use regression analyses to test my hypotheses regarding
the perceived interrelationship of barriers and control for a number of personal and business characteristics. I also test whether transition has an effect on perceived business barriers as measured by business start-up date: before or after 1994. The regression results based on logit and multinomial logit estimation models indicate a number of significant interrelations. For example, perceived formal barriers were found to be associated with perceived informal barriers related to corruption. In addition, perceived informal barriers were perceived to be significantly associated with perceived formal barriers such as taxation. Similar interrelations were identified between environmental barriers and skill barriers. Specific SME characteristics such as location, business facility ownership, turnover and SME owner characteristics such as age seem to influence the perceived effect of different types of business barriers. The interrelations between business barriers emphasizes, that a change in one type of barrier may lead not only to a change in the perception of this barrier but also in the perception of other types of barriers.

Chapter 7 focuses on the effect of gender, an informal 'institutional' barrier, on the business performance of SMEs. Descriptive statistics are used to first identify the similarities and differences between male and female SME owners. Regression models (Ordinary least squares, ordered probit and logit estimation models) are used to test business performance as measured by business size, business turnover, business success, business financial success and growth aspirations. My results indicate that female SME owners tend to have smaller businesses with lower business turnover and less business financial success, than male SME owners. However, in terms of business success and growth aspirations, there were no significant differences found between male and female SME owners in Lithuania. In general, these results seem to indicate that the transition process seems not to have had a significant influence on altering existing gendered expectations and stereotypes. Therefore it seems that in spite of the dramatic economic, social and political changes that have characterized the transition process, female SME owners tend to display similar characteristics to female SME owners in advanced western economies.
The theoretical implications for institutional theory, gender and theories regarding entrepreneurship as related to this thesis are briefly presented in Chapter 8. This thesis ends with policy recommendations in Chapter 9, specifically targeted for SMEs and based on four main approaches: legislative reform, proactive governmental approach, legitimacy through improved SME owner image, interactive institutional approach and the need for alliance building between SME owners, NGOs and governmental representatives.
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