By law and by custom: Factors affecting small and medium-sized enterprises during the transition in Lithuania
Aidis, R.K.

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Chapter 1: Lithuania

1.1 History

Lithuania has an area of 65 300 km² and is located on the Baltic Sea. It is bordered by Latvia on the north, Poland on the south, Russia’s Kaliningrad enclave on the west and Belarus on the east. The name Lithuania first appeared in written sources in 1009 AD. In the Middle Ages, Lithuania enjoyed a period of independent statehood and expansion. Mindaugas, Lithuania’s first king, united Lithuania into one country in 1236. Later, in 1386, the Lithuanian Grand Duke Jogaila wed Jadwiga of Poland and created a personal union between Lithuania and Poland. Under the rule of Grand Duke Vytautas (1392 - 1430) the Lithuanian Grand Duchy reestablished its sovereignty and enjoyed a period of expansion and its borders stretched to the Black Sea. In 1569, Lithuania formed a closer confederate union with Poland creating a joint parliament (Diet) but preserving their own military administration and law. Due to its weak central government, in the late eighteenth century, the Lithuanian-Polish commonwealth was partitioned and the greater part of Lithuania was incorporated into the Russian empire. As a consequence of the 1863 uprising, the Czar outlawed the public use of Lithuanian. Russification efforts intensified and in 1865 the publication of Lithuanian books was prohibited and this law was not repealed until 1904 (Vardys & Misiunas 1978:6). After 1906, the general relaxation of earlier restrictions such as allowing the publication of literature in Lithuanian and the participation in the Russian Duma election campaigns, contributed to the steady growth of national institutions in Lithuania such as Lithuanian language schools, political parties and newspapers.
The weakening and eventual collapse of the Russian and German empires during World War I provided Lithuania and its Baltic neighbors (Latvia and Estonia) with a unique opportunity for sovereignty. The representative body of all Lithuanian political parties officially declared the independence of Lithuania on February 16, 1918. Lithuania chose an assembly-type liberal democratic style of government that reflected the trends in Europe at that time. But Lithuania lacked the economic, social, political, cultural structures needed to support it. In the end as elsewhere in Europe at that time, the Lithuanian government's tendencies moved away from democratic liberalism towards authoritarianism (Vardy & Misiunas 1978:10). Further, Lithuania's independence was threatened by a Bolshevik invasion in 1919, a Polish invasion, an attempted coup d'etat that same year and recurrent financial crises (Suziedelis 1997:18).

In independent Lithuania, private enterprise and small and medium farm production dominated the economy. In the 1930's pork and dairy products accounted for the majority of Lithuania's exports and the most developed industries were in textiles and food processing (Suziedelis 1997). During its two decades of independence, it can be argued that Lithuania achieved almost universal literacy as well as a 'solid measure of economic progress' despite obstacles such as a lack of investment capital, a weak industrial base, the 1930's worldwide depression and the need to reorient its exports due to the 1932 German trade embargo (ibid. 25). In general, Lithuania enjoyed a higher standard of living than that in the USSR (under Stalin) or Poland (Vardy 1978:78).

Soviet Russia had signed a peace treaty on July 12, 1920 with the Republic of Lithuania renouncing (in perpetuity) all Russian claims on Lithuania. However, with the advent of World War II, the situation changed. On October 10, 1939, following the division of Poland between Germany and the Soviet Union, Lithuania was forced to accept a mutual assistance pact that authorized the Kremlin to keep Red Army bases on Lithuanian territory. This pact also allowed for the return of its former capital city Vilnius and surrounding areas from Poland which had been forcibly seized in 1920. This 'protectorate status' was changed to outright occupation in June 1940. Under Soviet occupation, mass deportations of Lithuanians occurred culminating in
June 14, 1941 just weeks before the German attack on the Soviet Union. In anticipation of the arrival of the Germans, a revolt against the Soviets in Lithuania broke out on June 23, 1941 and the restoration of independence was declared on the same day. However, Germany had other plans. By late July, the Germans had established Nazi commissars who assumed power throughout the country. Near the end of World War II, Soviet troops re-occupied Lithuania and in 1944 re-incorporated it into the USSR. This final Soviet ‘occupation’ lasted for almost five decades.

Resistance to Soviet occupation continued throughout Soviet rule. A guerilla war against the Soviets was fought for eight years (1944 – 1952) causing tens of thousands of causalities (Vardy & Misiunas 1978:16). Non-violent resistance continued culminating in The Chronicles of the Catholic Church in Lithuania, which collected and disseminated information about the persecution of Lithuanian Catholics and the suppression of national rights. Though severely persecuted, The Chronicles first appeared in 1972 and continued to be written, reproduced and smuggled to Western countries throughout the remaining Soviet period.

The occupation by both Soviet and Nazi forces had dramatic consequences for Lithuania’s demographic composition. In the early 1920’s, Lithuania’s population was estimated to be 2,250,000, of which 80 percent were ethnic Lithuanians, 7 percent Jews, 4 percent Germans, 3 percent Poles, 2.7 percent Russians and 3.3 percent other nationalities (Suziedelis 1997:23). Approximately three fourths of the population was engaged in agriculture. Further, before World War II, not a single Lithuanian city had a majority of Lithuanian speakers as inhabitants (ibid.)

Though it is difficult to provide accurate figures, Lithuania suffered a substantial population loss during and after World War II. The four main causes were: mass deportations (especially the educated classes such as intellectuals, landowners, etc.) under Stalin in 1941 and from 1945 onwards, the annihilation of the local Jewish populations during Nazi Germany’s occupation, mass emigration to the West during World War II, and war casualties and resistance fighters (freedom fighters) who continued to oppose Soviet rule. Though precise statistical data is unavailable, tables 1.1 through 1.3 provide an indication of the extent of population loss suffered from 1941 – 1953.
It is estimated that Lithuania lost from 892,200 to 1,247,200 of its population (approximately 35 – 40 percent of its total population) due to World War II, the occupation of both Nazi and Soviet forces and the annexation of Lithuania into the Soviet Union. Lithuania was only able to recover its pre war population level of 3,128,000 in 1970 (Suziedelis 1997:229).

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1 Executions include the period 1940 – 1941, the killings that occurred in June 1941 and executions conducted throughout this period in order to pacify the inhabitants of Lithuania.
2 Other sources estimate this figure to be 30,425 or as high as 34,260 individuals (Pajaujis-Javis 1980:42)
3 Other sources estimate a total number of 600,000 Lithuanians as being deported from 1941-1950 (Pajaujis-Javis 1980:42).
In terms of fertility, Lithuania’s total fertility rate has been decreasing since 1990. As table 1.4 shows, the natural population increase has been negative since the mid 1990s and the total fertility rate has been decreasing (table 1.5). Further, Lithuania has one of the highest suicide rates in Europe (approximately 77 suicides per 100,000 inhabitants in 2001) (Lithuanian Department of Statistics 2002).

Table 1.4: Natural population increase in Lithuania (rate per 1000 inhabitants)

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<tr>
<td>Increase</td>
<td>4.6</td>
<td>-1.1</td>
<td>-1.1</td>
<td>-0.9</td>
<td>-1.1</td>
<td>-1.0</td>
<td>-1.4</td>
<td>-2.6</td>
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Source: Lithuanian Department of Statistics (2002)

Table 1.5: Total Fertility Rate (1989 – 1999)

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<tbody>
<tr>
<td>Rate</td>
<td>1.997</td>
<td>2.000</td>
<td>1.970</td>
<td>1.890</td>
<td>1.670</td>
<td>1.540</td>
<td>1.490</td>
<td>1.430</td>
<td>1.390</td>
<td>1.360</td>
<td>1.350</td>
<td>-32.5</td>
</tr>
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</table>


In 2002, the vast majority of Lithuania’s 3.7 million inhabitants consider themselves to be Lithuanian by nationality (83.5 percent). The remaining 16.5 percent of the population is primarily made up of ethnic Poles (6.7 percent) and Russians (6.3 percent). About 56 percent of Lithuania’s inhabitants live in the three largest cities: Vilnius, Kaunas and Klaipeda. The high percentage of ethnically indigenous inhabitants both now and during the Soviet period seem to have been influenced both by the resistance fighters and by the nationalistic tendencies of A. Snieckus during his Communist Party leadership.

1.2 The Soviet experience (1944 – 1990)

It can be argued that Lithuania’s economic and social development under Soviet occupation was strongly influenced by the Lithuanian Communist Party’s first secretary, Antanas Snieckus (1903 – 1974). During Lithuania’s independence (1921 – 1944) Snieckus was an active member of the banned Lithuanian Communist Party and spent many years serving jail terms for his illegal activities or in exile in Moscow. After the annexation of Lithuania into the USSR, Snieckus became the highest-ranking communist official in Lithuania. During the Stalin years, Snieckus faithfully
followed the repressive policies dictated by Moscow including the mass deportation of Lithuanian citizens, russification of Lithuania, persecution of the Lithuanian Catholic church, collectivization and destruction of national culture.

Following Stalin’s death in 1953, however, Snieckus’s behavior changed and became more independent and positive towards Lithuanians (Tininis 1995). Snieckus supported the appointment of Lithuanians to decision-making positions within the Communist Party, took care of the Lithuanian party nomenclature, tolerated the development of national culture, attempted to strengthen and preserve traditional agriculture production\(^{13}\) (ignoring innovations suggested by Moscow) and did not promote Russian immigration to Lithuania (ibid.). For these reasons, Snieckus was often accused of being a ‘nationalist’ by high-ranking communist officials in Moscow as well as by Russian communists stationed in Lithuania. The more nationalistic-oriented approach adopted by Snieckus arguably had a pronounced impact on Soviet Lithuania’s development. It helped develop a strong cadre of high-ranking Lithuanian communist party officials and reduced the flow of Russian immigrants\(^{14}\).

The legacy of Snieckus’s policies seems to continue to influence the political process in Lithuania after it restored its independence in 1991. During the first democratic election (in post-Soviet Lithuania) the former high-ranking Soviet officials of Lithuania were brought back to power. This pattern has continued throughout the transition process. In 2002, many of Lithuania’s most powerful political figures (prime minister, head of parliament, members of parliament) are from the ranks of former high-level Communist Party members.

Snieckus’s policies seem to have left behind both a positive and negative legacy. On the one hand, they preserved the relative homogeneity of the Lithuanian population, but on the other hand, they seem to have led to the creation of a strong national Sovietized leadership that has a vested interest in maintaining established informal institutions. The retention of Communist elites in decision-making positions can arguably lead to strongly path dependence development characterized by an entrenchment of outdated informal institutions\(^ {15}\) (see Chapter 2.2 for a discussion of informal and formal institutions). These vested interests conflict with the development of a free market system within a democratic state\(^ {16}\).
Near the end of Soviet occupation, Lithuania enjoyed a strong agricultural sector, a high-level of industrialization, good infrastructure and a highly educated population. Further, Lithuania’s population enjoyed one of the highest living standards in the Soviet Union.

1.3 Restoration of Independence
Non-violent Lithuanian resistance gained momentum in the late 1980’s and prevailed in spite of Moscow’s provocations. On March 11, 1990, Lithuania was the first Soviet republic to declare its independence from the Soviet Union. Unfortunately, Lithuania’s independence was only internationally recognized more than a year later in August-September 1991. The interim period of ‘unrecognized’ independence caused severe economic problems in Lithuania, largely caused by the Soviet Union’s economic blockade that included the refusal to supply Lithuania with fuel. In addition, repressive measures instigated by Moscow and aimed at reinforcing Soviet power in Lithuania resulted in a number of deaths, murders and hundreds of injuries.

The new constitution of the republic of Lithuania was ratified in October 1992 and since 1993 Lithuania has been governed by a democratically elected president and a unicameral Parliament consisting of 141 members. By the end of 1992, Lithuania’s secession from the Soviet Union was formally completed (marked by the removal of all foreign troops from Lithuanian soil) at which time it embarked on an ambitious stabilisation and reform program supported by the International Monetary Fund (IMF) and the World Bank (WB).

In comparison to the other former Soviet republics, Lithuania’s economic performance has been quite good. However, the transition process has not been an easy experience for most of Lithuania’s inhabitants. In the early 1990’s inflation rates skyrocketed, purchasing power fell dramatically and unemployment levels continued to increase. In 1994, Lithuania’s gross domestic product (GDP) amounted to as little as 54 percent of its former amount in 1989. Even by 2000, GDP was only 66 percent of its pre-transition 1990 level (UNECE 2001:162). This economic decline is attributed mainly to difficulties in adjusting centralised economic management practices to market economy conditions, weak economic relations with other
European and world countries, shortcomings of the economic reform (such as the delayed introduction of the national currency and ineffective privatisation\textsuperscript{21}) and inadequate control of reforms especially in agriculture\textsuperscript{22}. Further there has also been increasing economic inequality and poverty amongst Lithuanian citizens. In 2000, 16 percent of the population in Lithuania lived below the World Bank’s poverty line (World Bank 2000).

By 2001, Lithuania’s economic position had improved somewhat as demonstrated by positive GDP growth (5.7 percent), a low level of annual inflation (1.3 percent) and a modest foreign debt and trade deficit. The percentage of GDP generated by the private sector has been steadily increasing since 1994 and in 2001 made up 73 percent of the GDP (see appendix 1.1). The growth of the private sector demonstrates Lithuania’s commitment to privatisation and development of a free market economy. Foreign direct investment (FDI) has also been increasing though is lower than that of the other two Baltic countries (Latvia and Estonia). The rapid decline in the importance of the agriculture sector (as a percent of GDP) has also been a positive development. In 1990 the agricultural sector contributed to more than 27 percent of the GDP whereas in 2000, its contribution had shrunk to less than 8 percent (EBRD 2001). Subsequently, the importance of the service sector in GDP has been increasing and by 2000 contributed close to 60 percent of the GDP (ibid.). The make up of the service sector, however, remains quite different than in European Union (EU) countries. In EU countries the service sector is made up primarily of banking, financial, business services and cultural, leisure and other personal services, transitional economies tend to have mostly retail trade activities and ‘overstaffed’ public sector represented in their service sectors (Mertzanis & Petrakos 1998:12).

Lithuania was the last of the three Baltic countries to introduce its national currency, the litas. Initially, coupons were introduced to replace the ruble and the official Lithuanian currency was introduced only in July 1993. In the beginning, the litas was allowed to float but was soon tied to US dollar at a fixed exchange rate. Lithuania’s close trade relations with Europe and desire to join the European Union has influenced the decision to tie the litas to the euro (since February 2, 2002).
Further progress has been made in establishing links with to the EU and the greater international community. In 1991, Lithuania became a member of the United Nations and the Organization for Security and Cooperation in Europe (OSCE). In 1993, Lithuania joined the Council of Europe. Formal accession negotiations for EU membership were started in February 2000 and Lithuania is expected to become a member of the EU in 2004. Lithuania joined the World Trade Organization (WTO) in 2001 and in November 2002, was invited to accession talks with the North Atlantic Treaty Organization (NATO).

In Lithuania as elsewhere in the former Soviet Bloc transition countries, economic reform heavily emphasized the privatisation of state-owned enterprises and the needs of the state-owned sector. In general, the focus was on rapid privatisation and reform rather than on the development of an entrepreneurial class\textsuperscript{23}. Acs and Audretsch (1993) identify one of the main challenges confronting Central and European countries to be the development of entrepreneurship in order to achieve a more balanced industrial sector. It can be argued that new firms are better at adapting to the radical switch from a centrally planned economy to new market conditions which necessitate new resource combinations and innovation. As Kontorovich (1997) observed there are three main actors on stage in post-centrally planned economies: communist-era firms, domestic entrepreneurs and foreigners. While privatised enterprises are frequently struggling with reform and restructuring and foreigners are grappling with limited information and insight, the new domestic entrepreneurs emerge as heroes of the transformation by default. Taking this into consideration, entrepreneurship and especially SMEs play an important role in Lithuania’s economic development.

1.4 Democratic reform

The 1992 Lithuanian constitution established a French-style, prime ministerial-presidential system with a split executive in which the president is the head of state and the prime minister is the head of government. The role of the president largely depends upon who controls parliament. When political parties opposed to the president dominate the parliament (seimas), then the powers of the president are largely ceremonial (Clark & Perkevicius 2000). Lithuania’s current president, Valdas Adamkus (elected in 1998), is a Lithuanian émigré from the United States who ran as
a non-partisan candidate. He replaced Algirdas Brazauskas who was also the former Lithuanian Communist Party First Secretary.

Lithuania's political system can be regarded as a stable democracy. National elections have taken place six times since 1990 with three presidential elections, in 1993 (Algirdas Brazauskas), in 1998 (Valdas Adamkus), and in 2003 (Rolandas Paksas) and four parliamentary elections (1990, 1992, 1996 and 2000). Recognition of Lithuania's political stability came from the Organization for Security and Cooperation in Europe (OSCE) who announced that they would not be sending observers during the October 2000 parliamentary elections. Another indication of Lithuania's democratic stability is the peaceful change of political party leadership that has occurred as a result of national elections outcomes. The party that led Lithuania to independence, Sajudis, which was in power from 1991 – 1992, lost out to the former Lithuanian Communist Party in the October 1992 parliamentary elections. In 1996, prominent members of the Sajudis party regrouped into the Fatherland Union (Conservative) party and won the majority of seats in the parliamentary elections. Dissatisfaction with the performance of the Fatherland Union party led by Vytautas Landsbergis, resulted in the victory of the Social Democrat Party and the New Union Party (both of which are substantially comprised of former Communist Party members) in the 2000 parliamentary elections.

However the new democratic system has experienced some 'growing pains'. In 1999 the government changed three times (following the resignation of two prime ministers and the appointment of a new prime minister at the end of 1999). Despite public dissatisfaction with the performance of state institutions, political elites and the public seem fully committed to free elections, a multi-party system and human rights (Clark & Bartels 1999).

It can be argued that that democratization process in Lithuania has been hampered by inherited legacies of Soviet rule. The devaluation of personal ethics, responsibility and the destruction of civil society resulted in widespread acceptance of Soviet-style corruption, bribery, the blat system and stealing from the state as socially legitimate means to survive (and sometimes prosper) within the constraints of the Soviet system. These values continue to inform the actions of individuals in the democratic, market-
oriented economy. This negative institutional legacy is further discussed in Chapter 2.2.

1.5 Transition – general trends

According to the Lithuanian Human Development Report (UNDP 1999; UNDP 2000) there has been an increase in the standard of living in Lithuania since the beginning of transition in the early 1990’s. Total disposable incomes have been rising and expenditures on food as a share of total expenditures have been decreasing. However, as table 1.6 shows, income inequality has also been increasing.

Table 1.6: Income inequality in Lithuania: Gini coefficient for per capita income

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<td>Gini coefficient</td>
<td>0.23</td>
<td>0.33</td>
<td>0.34</td>
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In 1998, the relationship of monetary consumer expenditure between the wealthiest decile and the poorest decile of the population differed by ten times and for food by five times (UNDP 1999). On average, in 1998, one tenth of the wealthiest households spent more than half (52 percent) of the total consumer expenditure (UNDP 1999:79). Though real Gross Domestic Product (GDP) in Lithuania experienced a dramatic decline in 1992 and continued to decline until 1994, it has been mainly increasing since 1995 (table 1.7). However, macroeconomic data for real GDP levels in Lithuania show that in 2001 the GDP level was still significantly below its 1989 pre-transition level (table 1.8).

Table 1.7: Growth in real GDP in Lithuania

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<tr>
<td>%</td>
<td>1.5</td>
<td>-5.0</td>
<td>-6.2</td>
<td>-4.3</td>
<td>-16.0</td>
<td>-9.5</td>
<td>3.5</td>
<td>4.9</td>
<td>7.4</td>
<td>5.2</td>
<td>-3.9</td>
<td>3.8</td>
<td>5.7</td>
<td>5.2</td>
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Source: EBRD (2001, 2002) * provisional data; * projection

Table 1.8: Real GDP in Lithuania (indices 1989 = 100)

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<tr>
<td>Index</td>
<td>100</td>
<td>96.7</td>
<td>91.2</td>
<td>71.8</td>
<td>60.2</td>
<td>54.3</td>
<td>56.1</td>
<td>58.7</td>
<td>63.0</td>
<td>66.2</td>
<td>63.6</td>
<td>66.1</td>
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Source: UNECE (2001:162)
A reasonable indicator of consumer demand can be obtained by looking at a comparison of the real total expenditure levels after the transition process had taken place. Though this data is only partially available for Lithuania (from 1995 onwards) we can assume that a similar trend took place in Lithuania as in its neighboring country Latvia (table 1.9). Data from Latvia show that real total consumption decreased significantly in the early 1990's and though it increased in the late 1990's, real total consumption expenditure was less than 61 percent of the 1990 level in 2000. This data indicates that consumer demand remains low.

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<tbody>
<tr>
<td>LV</td>
<td>100</td>
<td>76.7</td>
<td>49.2</td>
<td>46.5</td>
<td>47.4</td>
<td>47.0</td>
<td>50.8</td>
<td>52.7</td>
<td>56.0</td>
<td>58.2</td>
<td>60.4</td>
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<tr>
<td>LT</td>
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<td>---</td>
<td>---</td>
<td>100</td>
<td>108.2</td>
<td>116.4</td>
<td>125.4</td>
<td>122.4</td>
<td>126.8</td>
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</table>

Source: UNECE (2001:163)

Overall, we find that the general economic situation in Lithuania is improving both in terms of real GDP levels and the standard of living. What we also find is that in spite of these positive developments, the pre-transition levels of real GDP and real total consumption are still below the 1989/1990 levels. This contributes to low consumer demand. Further the increasing income inequality levels between the rich and the poor also reduces the level of internal demand for consumption goods as the wealthy can spend their income outside of Lithuania's borders.

1.6 Transition periods: pre 1994 and post 1994
Though Lithuania has not yet completed its transition to a market economy, two distinct transition periods can already be observed: before 1994 and after 1994\(^\text{26}\). The period before 1994 has been mainly characterized by negative economic developments such as '...a vast decrease in total industrial production, an upsurge in inflation, a decrease in domestic turnover and international trade, a fall in the standard of living, a weakening in labor and financial control' (UNDP 1999:61). The period after 1994, however, has been characterized by more positive economic developments. Post 1994 there has been a significant decrease in inflation and stable growth in GDP and investment (ibid.). The introduction of a currency board in April of 1994 pegging the Lithuanian litas to the US dollar seems to have been one of the
most important measures towards stabilizing the Lithuanian economy. Given that economy-wide effects of this change take time, we can expect to encounter a 'time lag' before we witness an improvement in other economic indicators. This seems in fact to be the case. For a number of economic indicators such as for overall GDP levels, industrial output, agricultural gross output and employment, clear improvements were registered only in 1995 (see appendix 1.1).

Further, most of the post-1994 economic improvements have been sustained. As the Lithuanian Human Development Report in 1997 notes:

_The encouraging signs of macroeconomic stabilization that appeared in 1994 have evolved into a sustainable economic revival. The continued decrease in inflation, the growth of GDP, increased foreign investment, relatively low and stable unemployment, favorable changes in the balance of payments and privatization are all indicators of a transformation within the Lithuanian economy (UNDP 1997:35)._  

A number of distinct changes characterize the periods before and after 1994, many of which have been sustained throughout the late 1990s (see appendix 1.1). The most significant improvements have taken place in terms of positive GDP growth registered from 1994-1995 (for the first time since 1990), the reduction in the annual inflation rate to under 40 percent in 1995 and net foreign direct investments which increased by 43 percent from 1994-1995. The private sector also dramatically increased its GDP contribution by 25 percent from 1993-1994. Previously declining output in both the industrial and agricultural sectors improved substantially in 1994-1995. Industrial gross output increased by 31.8 percent and agricultural gross output increased by 26 percent from 1994-1995. After experiencing much exchange rate instability, the exchange rate of the litas to the US dollar stabilized from 1994 onwards. A continuing positive trend has been the increase in GDP per capita with a large increase occurring from 1995-1996.

A combination of formal policies such as trade liberalization as well as the continuation of government subsidies to SOEs and mis-management has resulted in some negative developments. Lack of competitiveness of locally produced goods, international quality standards, other barriers to export trade and trade liberalization
policies have resulted in a disproportionate increase of imports as compared to exports. From 1994 to 1995, imports increased by 52 percent while exports only increased by 33 percent (see appendix 1.2). This negative trend of an increasing trade deficit has continued into the late 1990s. The current account balance experienced a major deterioration from 1992-1993 and again from 1994-1995.

Though Lithuania’s decision to adopt a fixed exchange rate regime by pegging the litas to the dollar seemed a wise move, the currency to which the litas is pegged has had to be changed. The 1998 Russian ruble crisis resulted in a sharp fall in external demand which coupled with a strong domestic demand has led to a growing current account deficit. In addition, the weakness of the euro (after its introduction in 1999) against the dollar has decreased the competitiveness of Lithuanian exports to European markets. Before the Russian crisis, Lithuanian authorities were already discussing the prospects of pegging the litas to the euro or a basket of the euro and the dollar. Since the beginning of 2002, the litas has been reppegged to the euro\textsuperscript{28}. The new euro peg is a positive step for Lithuania’s trade with the European Union countries which in 2002 made up 49.8 percent of Lithuanian exports and is expected to continue to grow in the future (Lithuanian Department of Statistics 2002). The rising value of the euro vis-à-vis the US dollar has had a positive effect for businesses trading within the euro zone but a negative effect for Lithuanian exports to the US. However, given that a sizeable amount of Lithuania’s external debt is in US dollars (approximately 61 percent in 1997), a fall of the euro against the US dollar would raise the domestic burden of foreign debt service (Nuti 2002:44).

**Enterprise growth.** In Lithuania, as in many other transition countries, private enterprise mushroomed during the initial transition period in the early 1990's. From 1993 – 1995 there has been a steadily increasing trend in the number of enterprises in Lithuania in all size categories (of registered businesses). As table 1.10 shows, the most rapid growth took place in the smallest size category (less than 5 employees and 5-19 workers) in 1993 – 1994. Enterprises with less than 5 employees increased by 48 percent and enterprises with 5 – 19 workers increased by 39 percent from 1993-1994. Since we can safely assume that the vast majority of the small-sized enterprises (up to 19 workers) are private businesses, this table provides a good indication of the changes in growth patterns of small enterprises. Based on this data, however, we
cannot say whether increased enterprise exits or decreased number of business start-ups was the main factor for the changes in growth.

Table 1.10: Number of functioning enterprises in Lithuania

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<tr>
<th></th>
<th>1993</th>
<th>1994</th>
<th>1995</th>
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<tbody>
<tr>
<td>Functioning enterprises</td>
<td>33 067</td>
<td>47 650</td>
<td>63 241</td>
</tr>
<tr>
<td>Less than 5 workers</td>
<td>24 214</td>
<td>35 865</td>
<td>48 321</td>
</tr>
<tr>
<td>5-19 workers</td>
<td>5123</td>
<td>7100</td>
<td>9151</td>
</tr>
<tr>
<td>20 – 199 workers</td>
<td>3348</td>
<td>4225</td>
<td>5192</td>
</tr>
<tr>
<td>200 + workers</td>
<td>382</td>
<td>460</td>
<td>577</td>
</tr>
</tbody>
</table>

Source: UNDP (1997)

Table 1.11 illustrates a slightly different trend for newly created private enterprises. According to the World Bank (1998), the number of newly registered private enterprises has been stable with a dramatic decline occurring in 1995.

Table 1.11: Number of newly created private enterprises by year of registration

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</tr>
</thead>
<tbody>
<tr>
<td>Number of new private enterprises</td>
<td>1,485</td>
<td>1,364</td>
<td>1,542</td>
<td>1,526</td>
<td>1,647</td>
<td>517</td>
<td>1,500</td>
</tr>
</tbody>
</table>


The lack of increasing numbers of SMEs is of concern and is most likely caused by a combination of micro- and macro-level conditions. The combination of increasing regulations (in the form of requirements, taxation, etc.) coupled with decreasing business opportunities (due to increasing competition) seem to have resulted in a failure of the number of new private enterprises to grow in 1990 - 1996. Figure 1.1 provides an indication of the frequency of changes that have taken place to tax laws in Lithuania.
Furthermore, the period from 1999 – 2000 has seen a decrease in the number of registered SMEs. At the beginning of 1999 there were 81 600 registered SMEs but by the end of 2000 there were only 52 000 registered SMEs (SMEDA 2002). The main factors influencing this rapid decrease seem to be both internal changes and external economic shocks. Internal changes included increased labor costs (for hiring employees), additional taxation, additional bureaucratic barriers, increased competition from large chain stores (especially for trade related businesses) and low consumer demand. External shocks included both the Russian ruble crisis (August 1998) and an increasingly unfavorable litas-euro exchange rate. The Lithuanian Human Development Report (UNDP 1999) noted that the Russian crisis was hardest on small businesses that were involved in trade with Russia. Since the litas was tied to the US dollar, the increasing value of the US dollar and the decreasing value of the euro resulted in Lithuania's exports being less competitive and made it more difficult for Lithuanian SMEs to engage in profitable export activities. In addition, a simplification of the regulations for de-registering inactive businesses in 2000 resulted in the de-registration of many inactive businesses which may have influenced the apparently large decline in private businesses from 1999 to 2000.
1.7 Conclusion

Historically, Lithuania has enjoyed periods of independence interspersed with foreign occupation. World War II and the annexation of Lithuania through incorporation into the Soviet Union had serious demographic and economic consequences. Approximately 35 to 40 percent of Lithuania’s population was lost due to murders, war casualties, massive deportations, refugee movements and repatriation. Economically, a centrally planned system was instigated to supplant Lithuania’s market oriented economy. Different forms of resistance including guerilla fighters and underground publications documenting Soviet persecutions continued to take place during Soviet rule.

The policies of Lithuania’s most influential Communist leader, Antanas Snieckus (1944 – 1974), left behind both positive and negative legacies. On the one hand, his policies helped preserve the relative homogeneity of the Lithuanian population. On the other hand, his policies helped develop a strong cadre of high-ranking Lithuanian Communist Party officials whose influence in independent Lithuania often conflict with the development of a free market system within a democratic state.

Lithuania’s independence was declared on March 11, 1990 and recognized internationally more than a year later in 1991. In comparison with other former Soviet republics, Lithuania’s economic performance has been quite good. As in other transition countries, economic reform heavily emphasized the privatization of state-owned enterprises and the needs of the state-owned sector. Little attention was paid to developing SMEs and a local entrepreneurial class.

Lithuania’s political system can be regarded as a stable democracy. Since independence, national elections have taken place seven times without great turmoil. However, the legacy of Soviet rule seems to continue to negatively influence the democratization process.

In spite of the positive economic development such as increasing real GDP levels and improvements to the standard of living, current levels of real GDP and real total consumption are still below the 1989/1990 levels. Two distinct periods can be
identified in the transition process thus far: pre 1994 and post 1994. The pre 1994 transition period is characterized by transition chaos and a general lack of a regulatory framework and the post 1994 period is characterized by increasing macroeconomic stabilization but also over regulation.

In Lithuania, private enterprise mushroomed during the initial transition period in the early 1990's. However the number of newly created registered private businesses and registered private businesses was stagnant in 1990 - 1996 with a dramatic decrease occurring in 1995. Furthermore, the number of registered SMEs fell sharply in 1999 – 2000. The lack of private sector growth is of concern. A number of factors are likely to be influencing this negative trend. The combination of increasing regulations (in the form of requirements, taxation, etc.) coupled with decreasing business opportunities (due to increasing competition) seem to influence the decreasing numbers of private enterprises. Further, the Russian ruble crisis in August 1998 was an unanticipated negative external shock that led to the bankruptcy of many SMEs in Lithuania. In addition, many registered private businesses are inactive. A simplification of the regulations for de-registering inactive businesses in 2000 resulted in the de-registration of many inactive businesses which may have influenced the apparently large decline in private businesses from 1999 to 2000.
### Appendix 1.1: Economic Indicators – Lithuania (1990 – 2003)

<table>
<thead>
<tr>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP*</td>
<td>-5.0</td>
<td>-6.2</td>
<td>-4.3</td>
<td>-16.0</td>
<td>-9.5</td>
<td>3.5</td>
<td>4.9</td>
<td>7.4</td>
<td>5.2</td>
<td>-3.9</td>
<td>3.8</td>
<td>5.7</td>
<td>5.2</td>
<td>3.0</td>
</tr>
<tr>
<td>Inflation*</td>
<td>8.4</td>
<td>224.7</td>
<td>1,020.5</td>
<td>410.4</td>
<td>72.1</td>
<td>39.6</td>
<td>24.6</td>
<td>8.9</td>
<td>5.1</td>
<td>0.8</td>
<td>1.0</td>
<td>1.3</td>
<td>3.3</td>
<td>2.4</td>
</tr>
<tr>
<td>GDP per capita(\uparrow)</td>
<td>na</td>
<td>289</td>
<td>514</td>
<td>715</td>
<td>1,166</td>
<td>1,667</td>
<td>2,200</td>
<td>2,691</td>
<td>3,039</td>
<td>3,036</td>
<td>3,237</td>
<td>3,450</td>
<td>na</td>
<td>na</td>
</tr>
<tr>
<td>FDI (net)*</td>
<td>na</td>
<td>na</td>
<td>na</td>
<td>30</td>
<td>31</td>
<td>72</td>
<td>152</td>
<td>328</td>
<td>921</td>
<td>478</td>
<td>375</td>
<td>439</td>
<td>395</td>
<td>na</td>
</tr>
<tr>
<td>Private sector share of GDP %*</td>
<td>10.0</td>
<td>10.0</td>
<td>20.0</td>
<td>35.0</td>
<td>60.0</td>
<td>65.0</td>
<td>70.0</td>
<td>70.0</td>
<td>70.0</td>
<td>70.0</td>
<td>73.0</td>
<td>na</td>
<td>na</td>
<td></td>
</tr>
<tr>
<td>Industrial gross output*</td>
<td>na</td>
<td>na</td>
<td>na</td>
<td>-34.4</td>
<td>-26.5</td>
<td>5.3</td>
<td>5.0</td>
<td>3.3</td>
<td>8.2</td>
<td>-11.2</td>
<td>5.3</td>
<td>16.9</td>
<td>na</td>
<td>na</td>
</tr>
<tr>
<td>Agricultural gross output*</td>
<td>na</td>
<td>-6.0</td>
<td>-23.0</td>
<td>-6.0</td>
<td>-20.0</td>
<td>11.0</td>
<td>12.6</td>
<td>8.6</td>
<td>-5.2</td>
<td>-14.5</td>
<td>5.4</td>
<td>-8.5</td>
<td>na</td>
<td>na</td>
</tr>
<tr>
<td>Labor force*</td>
<td>na</td>
<td>2.7</td>
<td>-1.2</td>
<td>-1.1</td>
<td>-6.4</td>
<td>0.7</td>
<td>-2.1</td>
<td>-5.7</td>
<td>0.8</td>
<td>1.0</td>
<td>-3.7</td>
<td>-1.9</td>
<td>na</td>
<td>na</td>
</tr>
<tr>
<td>Employment*</td>
<td>na</td>
<td>2.4</td>
<td>-2.2</td>
<td>-4.2</td>
<td>-5.8</td>
<td>-1.9</td>
<td>-0.7</td>
<td>-3.1</td>
<td>1.7</td>
<td>0.1</td>
<td>-5.0</td>
<td>-3.8</td>
<td>na</td>
<td>na</td>
</tr>
<tr>
<td>Unemployment rate(\downarrow)</td>
<td>na</td>
<td>na</td>
<td>na</td>
<td>na</td>
<td>3.8</td>
<td>6.1</td>
<td>7.1</td>
<td>5.9</td>
<td>6.9</td>
<td>8.1</td>
<td>11.2</td>
<td>12.8</td>
<td>11.8</td>
<td>na</td>
</tr>
<tr>
<td>Unemployment rate(\downarrow)</td>
<td>na</td>
<td>na</td>
<td>na</td>
<td>na</td>
<td>17.4</td>
<td>17.1</td>
<td>16.4</td>
<td>14.1</td>
<td>13.3</td>
<td>14.1</td>
<td>15.4</td>
<td>17.0</td>
<td>17.1</td>
<td>na</td>
</tr>
<tr>
<td>Exchange rate(\downarrow)</td>
<td>na</td>
<td>110.0</td>
<td>379.0</td>
<td>3.9</td>
<td>4.0</td>
<td>4.0</td>
<td>4.0</td>
<td>4.0</td>
<td>4.0</td>
<td>4.0</td>
<td>4.0</td>
<td>4.0</td>
<td>3.9034</td>
<td>na</td>
</tr>
</tbody>
</table>

* estimate; ** projection; \(\downarrow\) forecast; na = not available
* Percentage change in real terms; \(\uparrow\) Percentage change; \(\downarrow\) in US dollars at current exchange rates; * in millions of US dollars. Covers only investment in equity capital for 1993 and 1994; equity capital and reinvested earnings from 1995 onwards; * Annual average percentage change; \(\downarrow\) Year end, litas per $1 USD;
\(\downarrow\) Labor exchange office; \(\uparrow\) Labor force survey.
### Appendix 1.2: Current account and financial indicators – Lithuania (1990 - 2002)

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</tr>
</thead>
<tbody>
<tr>
<td>Exports*</td>
<td>na</td>
<td>na</td>
<td>1.142</td>
<td>2.026</td>
<td>2.029</td>
<td>2.706</td>
<td>3.413</td>
<td>4.192</td>
<td>3.962</td>
<td>3.147</td>
<td>4.050</td>
<td>4.739</td>
<td>4.952</td>
</tr>
<tr>
<td>Trade balance*</td>
<td>na</td>
<td>na</td>
<td>101</td>
<td>-155</td>
<td>-205</td>
<td>-698</td>
<td>-896</td>
<td>-1.147</td>
<td>-1.518</td>
<td>-1.405</td>
<td>-1.104</td>
<td>-1.090</td>
<td>-1.227</td>
</tr>
<tr>
<td>Current account*</td>
<td>na</td>
<td>na</td>
<td>203</td>
<td>-86</td>
<td>-94</td>
<td>-614</td>
<td>-723</td>
<td>-981</td>
<td>-1.298</td>
<td>-1.194</td>
<td>-675</td>
<td>-629</td>
<td>-855</td>
</tr>
<tr>
<td>Current account*</td>
<td>na</td>
<td>na</td>
<td>10.6</td>
<td>-3.2</td>
<td>-2.2</td>
<td>-10.2</td>
<td>-9.2</td>
<td>-10.2</td>
<td>-12.1</td>
<td>-11.2</td>
<td>-6.0</td>
<td>-5.8</td>
<td>-6.4</td>
</tr>
<tr>
<td>General govern't balance*</td>
<td>-5.4</td>
<td>2.7</td>
<td>0.5</td>
<td>-3.3</td>
<td>-5.5</td>
<td>-4.5</td>
<td>-4.5</td>
<td>-1.8</td>
<td>-5.9</td>
<td>-8.5</td>
<td>-2.7</td>
<td>-1.7</td>
<td>-1.5</td>
</tr>
</tbody>
</table>

Source: EBRD (2002)

* merchandise, in millions of US dollars; * in millions of US dollars; * as a percent of GDP.
* estimate; ** projection; na = not available
Chapter 1 Notes

1 Though Lithuanian language schools were banned, a dense network of clandestine schools emerged ensuring one of the highest literacy rates among the nationalities of the Russian empire (47 percent according to the 1897 census).

2 German troops were still present in Lithuania in February but left by the end of November 1918. During its period of independence, Lithuania was reduced in size. Though it had signed an armistice with Poland that acknowledged Lithuania's capital city Vilnius as part of Lithuania (October 7, 1920), within hours, the city and surrounding area were taken by force through a military action led by General Lucjan Zeligowski. Further in 1939, Hitler demanded that Lithuania surrender the city of Klaipeda and surrounding area which was incorporated into Nazi Germany (Vardys & Misiunas 1978).

3 It can be argued that 'societies [such as Lithuania] that had for centuries been ruled by the iron hand of foreigners were not ready for such a system of self-governance' (Vardys 1978:68).

4 The German occupation of Lithuania inflicted destruction on a scale that Lithuania had not encountered since the wars and pestilence in the early 18th century. Ninety percent of the local Jewish population was murdered. Nearly 500,000 inhabitants either fled or were forcibly evacuated eastward. Further, the German military administration exploited the country for the war effort through agricultural requisition and forced labor, arousing opposition among the population (Suziedelis 1997:17).

5 The Soviet occupation of Lithuania was completed only in January 28, 1945 with the capture of the Klaipeda region from Nazi Germany.

6 Given its clandestine nature, there are different estimates for the length of the guerilla war in Lithuania. According to Suziedelis, the guerrilla war took place from 1945 – 1954 and caused an estimated 50,000 deaths. Further, Suziedelis writes that though the armed resistance ended in 1953, isolated bands of resistance were reported in Lithuanian forests as late as the mid 1960's (1997:33).

7 There was a systematic policy put in place during the Stalinist era to deport, imprison and literally decimate the Lithuanian population. An article written in 1955 presenting these measures (emphasizing Latvia) ends with a chilling remark: The genocide of the Baltic population has been nearly completed (Saburova 1955:49).

8 Lithuania also gained population from the incorporation of the Vilnius region in 1939.

9 This figure also includes an influx of Russian settlers (Suziedelis 1997:229). By 1970, there were less than 2,500 Jews left in Lithuania (ibid. 142).

10 The total fertility rate in the other two Baltic countries Latvia and Estonia has fallen more sharply than Lithuanian’s total fertility rate. Decreasing fertility is also a general trend in other Baltic region countries such as Sweden (World Bank 2002).

11 The overwhelming majority of suicides are committed by men in rural areas. 53 percent of all suicide cases are between the ages of 35 and 59 years old.

12 Lithuanian passports make a distinction between citizenship and nationality. Though an individual is a Lithuanian citizen, he or she may consider himself or herself to be of a different nationality such as Russian, Polish, Ukrainian, etc. and this is indicated in his or her passport.

13 The greater emphasis on agricultural production and decreased emphasis on industrialization also resulted in fewer Russians being relocated to Lithuania.
According to the 1970 Soviet census, the percentage of Lithuania’s titular nationality in its total population actually increased from 79.3 percent in 1959 to 80.1 percent in 1970. The opposite trend occurred in Latvia and Estonia. Latvia’s titular nationality as a percentage of the population of Latvia decreased from 62 percent in 1959 to 56.8 percent in 1970. In Estonia the comparable percentage fell from 74.6 percent in 1959 to 68.2 percent in 1970 (Newth 1972:215).

Nepotism seems to be more prevalent in Lithuania than Latvia or Estonia mainly due to the fact that political power has not changed hands so drastically. In Soviet Latvia and Estonia, there were less ethnic Latvian or Estonian citizens in higher decision-making positions. After the reintroduction of independence, public servants were appointed mainly on ethnic grounds and as such there was a greater shift in political power (Norgaard 1996).

This was arguably not the only influencing factor. Lithuania’s industrial structure (dominated by large scale industries) and large agricultural sector also delayed Lithuania’s ability to quickly adapt a free market economy. In addition, the more politically and ideologically motivated quest for independence resulted in less emphasis being placed on economic efficiency and development than on national sovereignty.

The most bloody of which occurred in the pre-dawn hours of January 13, 1991 when Soviet troops stormed the Lithuanian TV tower and broadcasting facility in Vilnius killing 14 civilians and wounding hundreds more (Suziedelis 1997:42).

Previously Soviet troops.

For more detailed discussion see Knobl et al. 1993 and Saavalainen 1995.

Comparing the economic output in Soviet Lithuania and independent Lithuania is similar to comparing apples and oranges since the entire manner of measuring output was changed. Therefore comparing GDP levels before and after the transition process began is difficult. Though the exact figures may be incorrect, we believe that the tendencies indicated are correct.

For a discussion of Lithuania’s problems with mass privatization see Simenas in Buracas 1997.

During the period of economic crisis, agricultural production suffered the sharpest decline in output. Agricultural production which had occupied the dominant position in the national economy, gave way to the trade sector (which formed 24 percent of GDP in 1994) (Simenas in Buracas 1997). Due to poor control over and lack of responsibility for agrarian reform, much collective farm property has been plundered and devastated (see Povilunas in Buracas 1997).

OECD surveys of CEE countries

For example, OECD surveys of CEE countries in 1995 - 1996 all contain a section on privatization but hardly mention new business development.

A number of former Lithuanian communists formed a party called the Lithuanian Democratic Labor Party – LDLP. In 2000, this party fused with the Social Democrat party.

A Russian term describing the exchange of favors during Soviet times (Smallbone & Welter 2001b: 252).

From this point further we refer to these categories as before and after 1994, which implicitly compares businesses, started in or before 1994 to businesses started after 1994.

This change could also be strongly influenced by changes to statistical measurement since the data available shows only investment in equity capital for 1993 and 1994 but equity capital and reinvested earnings from 1995 onwards.

At a fixed exchange rate of 3.4528 litas per 1 euro.

A similar trend has been observed in Latvia (UNDP 1998b).
We focus our study here on legally registered private enterprises though in doing so, we are probably underestimating the true size of Lithuania’s private sector. A study ‘Preliminary Estimation of Monetary flows in Lithuania’ carried out by the Economic Research Center of Lithuania estimates that the ‘underground’ or informal economy accounts for 36 percent of GDP in 1994 and 41 percent of GDP in 1995 (World Bank 1998). A study carried out by the Lithuanian Department of Statistics estimates that in 1995 the informal economy accounted for 23.4 percent of GDP (Lithuanian Department of Statistics 1997). However, using the Russian case as an example, Kontorovich (1999) argues that the preferred strategy of informal activity is to register a business but hide earnings and employment. In this case, the distortion would more greatly affect the size and profitability of reported businesses than their actual number.

The number of registered SMEs is likely to include a significant percentage of inactive SMEs.
