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THE GOVERNANCE OF EMPLOYMENT AND ECONOMIC DEVELOPMENT IN THE BALTIC STATES^{*}

by

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Preliminary background report

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1. THE ECONOMIC AND EMPLOYMENT CONTEXT IN THE BALTIC STATES

1.1 Macroeconomic performance

1. As is rather well known during the early 1990s all three Baltic states suffered a rather severe ‘transitional recession’ with cumulative output declines in the region of 40-50%. Growth resumed at around 1995 and since then real GDP growth has been quite remarkable. Cumulative real GDP growth for the period 1996 to 2003 has been 51% for Estonia, 59% for Latvia and 52% for Lithuania. Moreover, the growth rates for the first half of 2004 show no signs of a slowdown – in fact quite the opposite. Table 1 below puts recent Baltic growth performance into a European perspective – growth in the Baltics has been better than in the New Member States (NMS-10) as a whole and much better than in the EU-15.

Country	1999	2000	2001	2002	2003
EU-15	2.9	3.5	1.6	1	0.7
NMS-10	3.3	4.1	2.4	2.5	3.6
EE	-0.1	7.8	6.4	7.2	5.1
LT	-1.7	3.9	6.4	6.8	9
LV	3.3	6.9	8	6.4	7.5

Source: Eurostat.

2. In all three countries growth has been generated by a combination of strong capital accumulation – investment as a share of GDP has been running at around 20% in Lithuania to 25-30% in Latvia and Estonia – and total factor productivity (TFP) growth. The two effects have had an approximately equal impact and have more than offset the impact of negative employment growth.¹

3. Nevertheless, there is a long way to go to achieve catch-up with the EU-15 – the Baltic states remain 3 of the 4 poorest EU member states, with Latvia in bottom place, Lithuania next and Estonia, which has recently overtaken Poland, now lies in fourth bottom place. However the gap to the next country is quite large.

4. On the potentially negative side, all three countries have been running persistent current account deficits – Latvia in the region of 8-10% of GDP and Lithuania at around 5-6% of GDP. However, in Estonia the deficit has steadily worsened from around 4% of GDP at the beginning of 2000 to around 14% at the end of 2003. However, these deficits have been substantially covered by inflows of FDI – especially in Estonia where cumulative FDI inflows have been twice as large as in Latvia and Lithuania.

5. In all three countries there has been a pre-accession surge of imports leading to large deficits in the second quarter of 2004 – 11% of GDP in Lithuania, 17% of GDP in Latvia and no less than 20% of GDP in Estonia.

¹ This is from a (so far unpublished) growth accounting study carried out by BICEPS for the World Bank.

6. After the initial stabilisation of the early 1990s inflation has generally been rather modest in all three countries. Between 1999 and 2003 prices in Latvia rose at around 2-3% a year, in Estonia at between 5.8% (in 2001) and 1.3% (in 2003), and in Lithuania at 1% or less and in 2003 prices actually fell by 1.1%. In all three countries there has been an EU accession price surge with inflation in Latvia running at an annual rate of 7.4% in the latter part of 2004, and in Estonia and Lithuania respectively by 4.7% and about 3%.

7. An important development in all three countries has been the emergence of a residential housing market with sharply rising property and land prices. This has been fuelled by historically low interest rates and the readiness of banks to lend freely. As a result the ratio of apartment prices to earnings is rather high by the standards of Western European countries, e.g. the UK. This makes the housing market and the banking sector potentially rather vulnerable to negative shocks.

1.2 Macroeconomic policies

8. The Baltic currency reforms are generally regarded as among the most successful of the Baltic reforms and among the most successful of the transition economies. Estonia went straight away in 1992 for a currency board with the Estonian kroon pegged initially to the D Mark and then to the euro. Lithuania formed a currency board arrangement in 1994 with a peg to the US dollar and repegged to the euro in February 2002. Both countries are now participating in the EU Exchange Rate Mechanism II as a prelude to probable entry into the Single Currency in two years time. By contrast the Latvian lats was pegged to the SDR² in 1994, without a currency board arrangement, and on December 30 2004 repegged to the euro. The fixed rate systems have survived a number of banking crises and most notably the Russian crisis of 1998.

9. All three countries have aimed to be fiscally prudent – most notably Estonia which has a zero budget deficit policy. In this Estonia has succeeded and has actually run a small budget surplus over 2001-2003. Latvia and Lithuania have been running budget deficits in the region of 2% of GDP.

10. Estonia and Latvia have flat rate income taxes at 26% and 25% respectively. In Lithuania income tax is 33% but some incomes are taxed at 15%. Income taxes are a major source of finance for local authorities. Corporate income tax is a flat 15% in Latvia and Lithuania but in Estonia it is zero on undistributed profits but the same as normal income tax on profits that are distributed. In all three countries social taxes are rather high which means that the ‘tax wedge’ on low incomes is rather high ranging from just over 37% in Estonia to nearly 41% in Latvia.

1.3 Labour markets

11. A major feature of the transition has been the dramatic fall in employment in all three countries – in Estonia employment fell by 30% between 1990 and 2000; in Latvia it fell by nearly 29% between 1990 and 2002; and in Lithuania employment fell by nearly 20% between 1991 and 2001. The fall in employment is a composite of the decline in working age population caused by migration of Russian citizens and industrial restructuring. The smaller employment decline in Lithuania reflects the fact that in 1990 it had a much smaller Russian population than either Latvia (which had the largest) or Estonia. Many previously resident Russians have migrated to Russia.

12. After some years of ‘jobless growth’ in the second half of the 1990s employment has started to pick up in all three countries in response to the persistently buoyant economies. Thus, according to Labour Force Survey data, in Estonia employment has grown by about 1% a year in each of the three years since

² Special Drawing Rights, the IMF unit of account.

2001, in Latvia employment growth has been about 2% a year over the same period, while in Lithuania employment growth was nearly 4% in 2002 and just over 2% in 2003.

13. The strongly growing economies have also had a noticeable impact on unemployment in all three countries. This is illustrated in Table 2 below:

Country	1999	2000	2001	2002	2003
EU-15	8.7	7.8	7.4	7.7	8
NMS-10	11.8	13.6	14.5	14.8	14.3
EE	11.3	12.5	11.8	9.5	10.1
LT	11.2	15.7	16.1	13.6	12.7
LV	14	13.7	12.9	12.6	10.5

Source: Eurostat

14. Not only has there been an improvement in overall unemployment, recent growth has had a positive impact on some of the most difficult areas of the labour market. For example Table 3 below shows recent developments in long-term unemployment.

Country	1999	2000	2001	2002	2003
EU-15	4	3.5	3.1	3.1	3.3
NMS-10	5.1	6.5	7.5	8.1	:
EE	5	5.7	5.7	5	4.6
LT	4.3	7.6	9.1	7.3	6.1
LV	7.6	7.9	7.2	5.7	4.3

Source: Eurostat.

* Persons unemployed for 12 months or more as % of active population.

15. The biggest impact on long-term unemployment has been in Latvia where the share of long-term unemployment has almost halved as compared with 1999. In Lithuania it is down by one third from a peak in 2001, while in Estonia the impact has been rather limited.

16. Other aspects of the labour market have also improved in one or more of the countries. For example, the employment rate of older workers (aged 55-64) has improved in all three countries and especially in Latvia and Estonia. This improvement has been especially marked among older women where the employment rate has gone up in 2003 by more than 12 percentage points from a share of 26.6% of the age group in 1999, and in Estonia by more than 8 percentage points from 39.2% in 1999. Generally the

employment rate of older workers in the Baltics is higher than in the EU-15 and much higher than in the NMS-10.

1.4 Regional disparities

17. Although the labour markets of the Baltic states are generally regarded as 'flexible' this seems to apply to mobility across jobs – as demonstrated for instance by evidence from Estonia (Cazes and Nesperova, 2001) on the length of stay in one job: they found that one in five people stayed in a job for less than a year, and older workers (over 45 years) on average have stayed less than 10 years with their employer (in USA it is 11 years). Wages too are regarded as flexible though we do not have formal evidence. However, regional labour market indicators, in Latvia and Estonia, indicate deep and persistent structural problems at the regional level, but less so in Lithuania. For example employment rates in the Estonian counties vary from nearly 63% in Tallinn to just over 43% in Voru. By contrast in Lithuania the highest employment rate is just over 66% in Taurage county (not Vilnius) and the lowest employment rate is as much as 54.5%. Regional employment rates in Latvia are reported by the five traditional regions (now also designated as planning regions) – Riga, Kurzeme, Latgale, Vidzeme, and Zemgale. These are larger than the counties of the other countries. Nevertheless, there are considerable disparities with the employment rate in Riga at 66% and in Latgale just 52%. There are also large disparities in unemployment rates.

18. The differences in employment and unemployment are reflected in regional differences in GDP per capita. Thus in Latvia in 2002 Riga had a GDP per capita at 182% of the national average, no other region exceeded 83% of the average and Latvia's poorest region Latgale had a GDP per capita income at 48% of the average. There is a similar story in Estonia with Tallinn at 153% of the national average, with the next highest region of five (Western Estonia) at nearly 73% and the poorest (Northeastern Estonia) at nearly 59%. In Lithuania we have data on GDP per capita by counties which should be more dispersed because the counties are somewhat smaller than the regions of of Estonia and Latvia, but GDP per capita in Vilnius county in 2002, the richest at nearly 144% of the national average, was only about 2.5 times higher than the poorest, Taurage which had just over 57%. Apart from Vilnius county, Klaipeda also had a per capita GDP in excess of the national average at nearly 109%. Although not insignificant, Lithuania's regional income disparities are much less acute than in Latvia and Estonia. However, it should be said that the disparities have worsened as compared with 2000 – Vilnius has become richer (in 2000 its per capita income was only 134% of the national average) and the poorest is poorer (Taurages was just over 60% of the national average in 200).

2. INSTITUTIONAL ASPECTS OF ECONOMIC DEVELOPMENT

2.1 Introduction

19. In any country that functions as a market economy economic development is supported by a variety of policies and ‘institutions’. At the national level there are basic macro economic policies, already briefly discussed in Section 1, which are implemented by national level institutions such as the central bank and the finance ministry. There are also national level rules and laws governing activities such as enterprise formation, enterprise activity, freedom of association etc that are governed in part by the courts, in part by specialised agencies such as an enterprise registration agency, and partly by local authorities in various functions such as planning or zoning. There are also sector-specific or theme-specific policies e.g. scaling down of a declining industry (say steel), or promotion of innovation, that are typically implemented by ministries and specialised agencies, possibly in collaboration with local authorities. Thus, typically, there is a complex system of institutions and responsibilities that has evolved over time in response to changing needs and possibly merely to changing fashions.

20. The starting point of any assessment of the institutional aspects of economic development in the Baltic states must be their shared history of 50 years as Soviet republics. This means that not only did they possess none of the institutions of a modern market economy, but also, in contrast to other central and Eastern European countries they had no experience of independent statehood and of independent policy making. The consequence was that in the early transition there was a tendency to go for widely different ‘solutions’ – for example, in trade policy, Estonia went straight away for the highly liberal ‘zero option’ of completely free trade, whereas Latvia in the first instance introduced extensive quantitative restrictions on trade which, prompted by international institutions such as the IMF and the World Bank, were quite quickly removed and replaced by gradually more modest tariffs.

21. The role of the international institutions, in the first instance, and of the EU subsequently has been quite crucial in the institutional development of the Baltic states. In the first instance the international institutions managed to steer the three countries away from what they regarded as ‘extreme’ solutions³ and subsequently (after 1995 when the three countries applied for EU membership and were accepted as EU Associate countries) the EU accession process has provided a template for many institutional developments.

22. Thus the current institutional framework for economic development is in many ways the product of this EU template – this has applied to the basic legal framework regarding economy as well as in more specific instances such as the regulation of, say, utilities where the EU has insisted on the creation of independent utility regulators as opposed to ones that were in danger of being ‘captured’ by the regulated sector. Nevertheless, the three countries remain different in many ways not least in their local government structures and in the style in which policies are developed and applied.

23. The key micro level policy areas supporting economic development have been rather similar in all three countries, namely:

³ Though it has to be said that initially the IMF opposed both the creation of the Latvian transitional currency and the Estonian currency board but both central banks went ahead against IMF advice.

- Small and medium sized enterprises (SMEs).
- Entrepreneurship.
- Innovation.
- Regional policy.
- Tourism.
- Structural funds.

24. It has to be said at the start, that policy-making in most of these areas has in all three countries by and large originated with central government – in the relevant ministry – often with the production of a policy paper (concept), followed by the formulation of a programme, and finally (sometimes) followed by implementation. The involvement of other actors – local governments, social partners, etc. – often (but not always) has come at a consultation phase after the policy paper or programme has been written.

25. Since the various tiers of local government are potentially key actor in the implementation of many policies we first offer a brief account of local and regional government in each country and this is followed by a description of the structure and development of the institutions supporting economic development in each country.

2.2 Regional and local government

26. Local government was a focus of the independence movements in all three countries even before the break-up of the Soviet Union led to restoration of full independence. Thus national level democracy preceded by democracy at the local level when in 1989 the local government elections were the first democratic elections of the post-war period. They were the first elections in which seats were contested and in which the principle of majority rule was accepted. Thus all three countries entered the independence period with local government structures inherited from the Soviet Union. In the early years of transition a variety of laws were passed legitimising local governments and defining their functions. In the process there was a substantial restructuring of the whole system in Lithuania and in Estonia a significant delegation of responsibilities to lower tiers. In Estonia the central government was “very eager to delegate as much responsibility as possible (...) to municipalities” (Nordregio, p17). Table 4 below shows the structural changes implemented in the 1990s.

Table 4: Changes in the local government system in the Baltic states during the 1990s

Country, population	At the beginning of transition		By the end of decade	
	tiers	local government units	tiers	local government units
Estonia 1.37 mn	2	249	1	247
Latvia 2.37 mn	2	559	2	552

Lithuania 3.45 mn	2	526	1	56
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Source: Vanags and Vilka.

27. Estonia and Lithuania also moved from a two-tier structure of elected local government to a single tier structure.

28. During the 1990s all three countries adopted the European Charter of Local Self-Government: Estonia did so in 1994, Latvia in 1996 and Lithuania in 1999.

Estonia

29. The territory of Estonia is divided into 15 counties and 241 municipalities (municipalities are divided into towns and rural municipalities). Local governments were re-established in Estonia in November 1989 and the first elections were held in December of the same year. Soviet time *rajoons* were renamed as counties and the municipalities corresponded more or less to Soviet primary administrative units. Initially there was also a secondary level formed by 15 counties and 6 republican towns. However, the current structure is a single tier system introduced by the Law on Local Governments, adopted in 1993. The law stipulates that towns and rural municipalities are local self governing units while counties are part of the central government. The counties have no elected bodies. County governors are appointed by the central government in consultation with the municipalities of the territory covered by the county.

Table 5: Estonian Counties and population on January 1st 2003

County	Population	Towns	Rural municipalities	Self governing units	Development plan adopted
Harju	505 563	6	19	25	23
Hiiumaa	11 340	1	4	5	5
Ida Viru	183 449	7	16	23	20
Jõgeva	39 144	3	10	13	13
Järva	40 145	2	14	16	16
Lääne	29 799	1	11	12	11
Lääne-Viru	69 980	4	14	18	17
Põlva	33 601	1	13	14	13
Pärnu	91 627	3	20	23	23
Rapla	38 523		10	10	10
Saare	37 987	1	15	16	14
Tartu	149 965	3	19	22	20
Valga	36 715	2	11	13	13
Viljandi	59 065	4	14	18	18
Võru	40 813	1	12	13	13
Total	1 367 716	39	202	241	229

Source: Ministry of the Interior and the internet portal of municipalities <http://portaal.eil.ee/arengukavad>.

30. Estonian municipalities are responsible for basic education, social services and primary health care, housing, water supply, sewage, physical planning, municipal public transport and maintenance of roads. The tax base of municipalities is closely tied to national taxes, which has contributed to a low predictability of revenues. However, the primary problem is the uneven potential of municipalities, as many municipalities are very small. About one half of the municipalities have less than 2 000 inhabitants. In an analysis of the performance of Estonian local authorities, Reiljan and Timpmann find that

municipalities with less than 3 000 inhabitants have difficulties in carrying out their basic functions because of insufficient funds (Janno Reiljan and Kadi Timpmann, 2001, Focal Points in the Development of Estonian Public Administration System, Tartu University.)

Table 6: The size of Estonian municipalities in 2003

Number of inhabitants	Towns	Rural municipalities	Total
0-1 000	-	27	27
1 001-2 000	6	92	98
2 001-5 000	8	64	72
5 001-10 000	11	19	30
10 001-	14	-	14
Total	39	202	241

Source: Ministry of the Interior

31. Two reform themes have been and remain under discussion: one concerns the size of municipalities and the other concerns introduction of a second-tier of local government. In 1995 municipalities were given the right to merge with neighbouring municipalities. However, the idea of mergers or amalgamations has found very little support among the municipalities themselves. Central government has attempted incentives to stimulate mergers, offering one million kroons (nearly 64 000 euro) to merging municipalities. In practice, however, the municipalities have to bear considerable costs themselves, which has limited adoption of the reform (Reiljan and Timpmann). In July 2000 a new reform strategy was initiated by the Ministry of Interior. A main goal was to increase the administrative capacity of the municipalities. However, one of the means of improving the administrative capacity was to create larger municipalities by voluntary mergers. But mergers still have very low support from municipalities. Further monetary incentives have been offered but to date the number of municipalities has decreased by just six to 241 from 247 in 2000 as against a reform target of 108.

32. The other theme of reforms concerns the creation of a second tier of local government. A new politically-elected county council would replace the current appointed county governor. According to the proposal, municipalities on the territory of the county would elect representatives from members of the municipal governments. The idea is to transfer some of the responsibilities of municipalities to the county level. A new body, *maakogu* would be created and it, the *maakogu*, would elect the county governor. This is similar to the Latvian system except that the municipalities would elect the whole county council rather than just the governor (or mayor) as in Latvia.

Latvia

33. Latvia has two levels of local government. Governments in the first tier are known as towns (*pilseta*), villages (*pagasts*), and *novads*. The last named is a form that is an amalgamation of several smaller municipalities (towns and villages) which have been encouraged under the 1998 Act on Administrative Territorial Reform. Latvia's seven republican cities have the rights and responsibilities of local governments.

34. All municipalities are governed by elected councils, which in larger cities are elected by party list. In some municipalities, especially in small ones, groups of candidates form their own list without party affiliation. Once elected, the councillors elect a chairman (mayor), who acts as the chief executive. Under the local government law, councils are obliged to appoint an executive director (on the recommendation of the mayor). In small municipalities, the mayor may also act as executive director. In addition to the usual functions and responsibilities of local government, Latvian municipalities have a responsibility for promoting entrepreneurship as well as to prevent unemployment and provide temporary paid work for the unemployed.

35. The second tier of local government consists of 26 *rajons*, or districts. The seven republican cities also function as districts. Before 1997, district councils were directly elected and hence had a political identity separate from the municipalities (except in the republican cities where the council took on both sets of responsibilities). Since then the districts have been governed by councils made up of the mayors of the municipalities within their territory. The districts perform a largely coordinating role and have few independent functions of their own.

36. As in Estonia most Latvian municipalities are very small – more than 70% have a population that is less than 2000. In fact the average population size of rural municipalities is only just over 1500. As a consequence a main aim of reform has been to promote the amalgamation of municipalities which are large enough to enable the provision of high quality services as well as to promote local economic development. This reform was envisaged as in the first instance voluntary with the latest deadline expiring at the end of 2004. However, the take up has been modest – at the latest count there were 26 amalgamated municipalities (*novadi*) thus reducing the number of municipalities to 504 as against a target of 102. The new minister for Regional Development and Local Government has stated that despite these slow developments he does not intend to force amalgamations.

37. Local authorities are represented by Union of Local and Regional Governments of Latvia in negotiations with the government and in bodies where local governments are represented.

38. For finance municipalities rely mostly on the personal income tax, followed by grants from the central government. Some revenues come from property taxes and from non-tax sources such as income from entrepreneurial activities, fines, and fees. Latvian municipalities are constrained in their ability to borrow – they are barred from raising loans on national or international capital markets and can turn only to the State Treasury or in certain circumstances to the Municipal Development Fund and Latvian Environmental Investment Fund.

Lithuania

39. As is clear from Table 4 above Lithuania is the only one of the Baltic states that has managed a comprehensive reform of its local government system. This was effected in 1995 when the previous two tier system was abolished. Thus at present Lithuania has only 2 levels of elected government – national and municipal. The reform radically reduced the number of elected municipalities and at the same time introduced counties which were a totally new arm of the regional state administration that operates at a level above the new municipalities. Currently there are 60 municipalities and 10 counties where the county level administrations are appointed by the national government.

40. Municipalities are classified as “City” and “District” type local authorities (LA) and some city LAs are geographically surrounded by a single district LA (e.g. Siauliai City is surrounded by Siauliai District). Some municipalities are further subdivided into neighbourhoods for administrative purposes – these are essentially based on the pre-reform lowest level municipalities.

41. The present structure is a result of a 2000 reform that increased number of municipalities from 56 to 60. Additional municipalities were created in Kalvarija, Kazlu Ruda, Pegege, Rietava & Elektrenai and the Marijampole District was eliminated (divided between Kalvarija and Kazlu Ruda). At same time Vilnius City gained territory from Vilnius District.
42. Local councils are elected from party lists under a PR voting system, the council then elects its leader, the mayor. However the Lithuanian Constitution provides for control of LA matters by Parliament, severely limiting municipal autonomy.
43. The basic law on local government is the *Law on Local Self-Government*, which was passed in 1994 and has been amended 36 times as of the beginning of 2004.
44. The Law divides local authority functions into four categories, according to how much formal independent decision-making power belongs to the municipality.
45. The four categories are:
- Independent – that is functions in which the municipality has complete freedom of action e.g. pre-school education.
 - Assigned – that is functions which are basically assigned by the state but where the LA has some decision-making power, e.g. transport for rural pupils.
 - State – these are functions completely controlled by the state though carried out by the LA e.g. compulsory school age education.
 - Agreed – new functions negotiated between the state and LAs as to budget and administrative features.
46. The law also provides for election of a community representative for a living place or group of living places. The lowest level of democratic government is the elected cooperative housing administration, deciding issues such as heating level and building renovation expenditures.
47. The Law names the Lithuanian Association of Local Authorities as the institution to represent municipalities in national and other negotiations.
48. There is not much financial independence for municipalities, 56% of their revenue in 2005 will come from specific (categorical) grants, mostly the pupil basket grant, i.e. finance of compulsory age education.
49. The financial independence of LAs varies, e.g. for Pagege 68% of the budget approved by Parliament for 2005 comes from specific grants, vs. only 13% for Neringa. However, overall 7% of revenue comes from wealth taxes, that can be levied by LAs, but in practice this proportion also varies from 25% in Palanga to 1% in Visaginas.
50. Much LA expenditure is either for administration of national functions or is heavily regulated so as to leave little decision-making power in the hands of the LA. The major areas that LAs control are pre-school education and public works (e.g. sweeping and snow clearing). Apart from general education, the major budget items for state functions administered by LAs include administration of welfare payments, transport discounts for certain demographic groups, and fire services.

51. The reform has left Lithuania with municipalities that are very large by European standards (except UK) – average population is 58 000. Also unusual is complete absence of LAs with less than 2,000 population (smallest population is Neringa with 2.4 thsd).

52. The Lithuanian counties (see Table 7 below for some data) have much the same functions.

Table 7: Basic characteristics of Lithuania's 10 counties in 2003

	Population in 2003	GDP in 2002 (€ mln)	GDP in 2002 (% of national)	GDP per capita in 2002 (€ thsd)	Average recorded wage in 2002 (€)	Registered unemployment rate in 2002	Infant mortality (under 1 year of age per 1,000 live births)
Alytus	186,340	607.1	4.1	3.2	255	14.2	10.7
Kaunas	696,143	2,799.4	19.1	4.0	271	8.8	6.6
Klaipeda	382,945	1,767.3	12.0	4.6	287	10.0	9.3
Marijampole	187,607	527.9	3.6	2.8	233	14.8	7.9
Panevezys	297,521	1,081.9	7.4	3.6	260	15.5	5.8
Siauliai	367,166	1,143.2	7.8	3.1	238	14.2	9.9
Taurage	133,473	324.3	2.2	2.4	220	14.6	7.2
Telsiai	179,137	632.5	4.3	3.5	284	15.9	7.0
Utena	183,131	633.5	4.3	3.4	309	11.0	7.5
Vilnius	848,090	5,150.8	35.1	6.1	341	8.7	7.8
Lithuania	3,462,553	14,667.9	100.0	4.2	293	11.3	7.9

Sources: Statistics Lithuania (2003). *Counties of Lithuania; Economic and Social Development 2002* (Vilnius), Bank of Lithuania website <www.lbank.lt>, own calculations.

53. as their counterparts in Estonia and Latvia, namely they act as a coordinating agent of central government. The county governor implements state policy in education, social services, health care, culture, environmental protection, agriculture and also has responsibility for territorial planning. The county governor has the right to participate in cabinet meetings of the central government if the agenda includes topic that affect the interests of the county.

Summary

54. It is clear that in Estonia and Latvia, the main problem of local governments is that many of them are too small to function effectively. It is partly a problem of funds – small rural municipalities are very likely to be poor also – but also a matter of economies of scale and of the ability to attract high quality professional staff. However, the municipalities are jealous of their independence and reluctant to dilute it through mergers and amalgamations.

2.3 Overview of institutional development

Estonia

55. The early legislation on enterprises included the enterprise law of November 1989 and the Law on Ownership in June 1990. The Law on Ownership recognised private ownership and granted equal status as between private ownership and other types of ownership. The Ownership Law also formulated the legal basis for privatising state property. In 1995 a new law regulating enterprises came into force, the Commercial Law. The new law filled gaps in the early legislation by being specific about enterprise

governance, including definitions of the functions of the Board of Directors of joint stock companies. The Commercial Law was also the basis for establishing a uniform commercial register in Estonia. The first Bankruptcy Law came into effect in September 1992 and was amended in 1997. It has been compulsory to register in the commercial register since 1997. The growth of enterprises has been rapid. Since 1997 about 10 000 new enterprises have been established annually, whereas the number of enterprise deaths has been relatively small, the number is about one tenth of the number of new businesses (Kuura, 2001).

56. The development of the private economy was spontaneous as well as influenced by policy choices that were made about how to privatise former state property. For enterprise privatisation, Estonia adopted an entrepreneurial approach, meaning an early ownership transfer of state-owned enterprises to strategic investors, mainly for money. By 1996 more than 90 percent of formerly state-owned enterprises had been privatised (Terk, 2000) According to estimates about 20 percent of enterprises were privatised to employees and 25 percent to management, which implies that 45 percent of the enterprises were privatised to insiders and the rest to outsiders (Eesti majandus, 1999).

57. The first support systems for enterprises developed spontaneously outside the public sector, created by businesses themselves. The current Estonian Employers Confederation was established on November 29, 1997, however it has its roots an organisation of industry established in 1917 and re-established in 1991. The Estonian Employers Confederation has twenty four business organisations as its members, representing 1 500 employers and represents them in the relations with legislative and executive authorities and the representatives of employees. In 1989, the Estonian Chamber of Commerce and Industry (ECCI) was re-established with some hundred members. As of August 25th 2003, the ECCI had 3 340 members. A Small and Medium Sized Enterprise Association (EVEA) was founded in the beginning of the 1990s. It has about 400 member companies. The association offers training, legal help and business consultations.

58. The starting point for public sector support for business was in 1996 when the Regional Development Foundation was established and created a regional network of centres with representation in all of Estonia's counties. These Regional Enterprise Centres offer support schemes and services to local entrepreneurs. In 1997-2000 several other support schemes were introduced. All support programmes were developed at the ministry level. The support structure was reorganised in 2000 when eight different foundations were merged into two: Enterprise Estonia (EAS) and KredEx. Enterprise Estonia offers support programmes for business start-ups, training programmes, export planning, product development and R&D financing. Besides export credits, KredEx offers loan guarantees for companies whose self-financing is not sufficient or if the company lacks a credit history for getting a bank loan.

59. As mentioned in Section 1, at the national level uneven economic growth has received much attention as the regional development has been strongly polarised to the territory around Tallinn, the capital city. Programmes for economic development exist in all 15 counties. However, since counties are a part of the central government, it is questionable whether the programmes can be classified as regional.

60. Municipalities generally have no economic development plans. However, Tallinn differs in this respect. Tallinn introduced a programme for small business development in February 2002. The background was that the governmental support schemes for small enterprises do not apply for businesses registered in Tallinn, since economic growth of the capital region has not been considered a problem. The programme of the City of Tallinn has two purposes: one is to increase the competitiveness of small enterprises by primarily supporting technologically based SMEs and the other is to boost entrepreneurship in order to improve the rate of employment in Tallinn. The programme includes different support schemes including start-up support and apprentice support. The City has also launched an incubation programme and started developing a science park at Tallinn University of Technology. The science park Tallinn

Tehnopol was established in March 2003 by the City in co-operation with Tallinn University of Technology and the Ministry of Economic Affairs and Communications.

Latvia

61. In Latvia the institutional basis for a market economy started in September 1990 when the law "On Entrepreneurial Activity" was adopted. This law defined general matters concerning the establishment, registration, management, and dissolution of enterprises. A Law on Joint Stock Companies followed in 1993, a Law on Credit Institutions in 1995, on bankruptcy in 1996 and so on. Thus, by 1999 the EU in its regular report on Latvia's progress in meeting the Copenhagen criteria was able to report that: "Latvia can be regarded as a functioning market economy. The legislative framework for business activity is in place" [EU Regular Report, 1999].

62. A new EU-compliant Commercial Law came into force in January 2002 which amongst other things simplified the procedures for registering business which are now quite streamlined by international standards.

63. As in Estonia entrepreneurs were quick to organise – the Latvian Chamber of Commerce (LCCI) and Industry was formed in 1990 and the Latvian Employers Confederation (LEC) in 1993. The LEC was quickly involved as the social partner on the employer side in the first tripartite cooperation council which was also created in 1993 and both the LEC and the LCCI are founder members of the National Economic Council created in 1999.

64. Many of the areas of economic development policy – entrepreneurship, SMEs, innovation, tourism – are implemented by the Economics Ministry. Policy is defined through a series of 'national programmes', e.g. the National Innovation Programme 2003-2006, the SME Programme 2004-2006, or the National Tourism Programme 2000-2010. The Economics Ministry is also the co-ordinating ministry for the National Action Plan for Employment (NAPE) – more on this in the employment section below – and has also developed strategy documents such as the Long-term Economic Strategy for Latvia and the Single Strategy Document.

65. Regional development policy and responsibility for the National Development Plan (the basis for the Single Programming Document, SPD) rests with the Ministry for Regional Development and Local Government.

66. In the past the typical procedure for developing the national programmes has been rather top down, with the draft document written by civil servants sometimes with the help of academic or consultant inputs, often to a template drawn from elsewhere (abroad). Once a draft is ready there are consultations with the National Economic Council, which is composed of representatives from business, trade unions and local authorities and with other affected sectors or organisations such as for example the recently formed (2003) Council of Small and Medium Sized and Crafts Enterprises of Latvia (this council consists of representatives of 27 regional and SME organisations) or with the Foreign Investors Council of Latvia.

67. There appears to be a gradual shift towards more broadly and locally based consultation e.g. as with the creation of the Council for Small and Medium Sized and Crafts Enterprises of Latvia.

Lithuania

The role of the various tiers of government

68. Economic development planning has been largely concentrated in the hands of national government in Lithuania. When a new governing coalition is formed it has to produce a programme for the

its term of office and this must be approved by Parliament before the new government can be installed. Since this government programme is the result of sensitive negotiations between coalition partners, all subsequent government economic planning must adhere to the objectives it sets out. In November 2001, however, there was an attempt by the Ministry of Economy to bring in policy advice from outside the government. As part of the preparation of the *Long-term Lithuanian Economic Development Strategy*, the Ministry established 14 expert groups led by academics in the respective field. The resulting document was approved by the government in June 2002 but was never presented for approval to parliament. Instead an alternative document, the *Long-term State Development Strategy* was prepared completely within national government structures, after a government directive assigned responsibility for preparing each section to national ministries in December 2001. This latter strategy was approved by the government in July 2002 and by Parliament in November 2002. In April 2003 an Implementation and Monitoring Oversight Commission was established without any representation from local or regional institutions.

69. The Single Programming Document was the first time that the government (led by the Ministry of Finance) conducted wider consultations, including with municipalities and business associations. The SPD working group included the Lithuanian Association of Local Authorities (LALA), as well as business and union confederations. May 2002 started the process with the conference “Partnership in the Planning of EU Financial Assistance”, where 150 social partners participated. All partners also invited onto ministry led sector specific SPD working groups. The conference presented SPD priorities and implementation measures and took feedback on desired directions of socio-economic development & opportunities for further partnership. In September and October 2002, there were informal consultation seminars in each of the 10 counties. Then partners themselves organised their own SPD seminars, inviting ministry representatives. This was done by the LALA, the Confederation of Lithuanian Industrialists, etc. The Ministry of Finance alone took part in 70 of these partner-organised events. Consultations with local authorities, the LALA and counties were particularly intense in the following areas: “Reinforcement of partnership capacities”, regional policy, “Effective use of EU SF Financial Assistance”, “Participation of Lithuanian municipalities in the preparation and implementation of the SPD”, “Role of the municipalities and their abilities to absorb EU structural assistance”, “Lithuanian self-government today and in future”, “European Future in Visaginas”.

70. The consultations for the Single Programming Document may have created a useful precedent. In December 2004, the LALA contacted Ministry of Economy regarding the *Small and Medium Sized Enterprise Development Tools for 2005* draft government decision. The local authorities are involved in the creation of regional plans, e.g. participation in working groups for preparation of Vilnius County development plan by experts and division heads from all the county’s local authorities.

71. Counties and municipalities are also responsible for producing their own economic plans. The capital, Vilnius, has published the *Vilnius City Strategic Plan 2002-2011*. All the counties have produced economics plans. In the county plans priorities tend to include everything, its difficult to conceive of a project that would fall outside of one of the priorities. However, the plans also contain specific projects and six of the ten counties give criteria for success, date of completion, and funds required by source. Hence this becomes the focus of the plan. The Kaunas County and Vilnius County plans do not include budget allocations but only list means for reaching objectives. Some of the listed means are fairly specific though, e.g. “Prepare a human capital study of Kaunas region, as a necessary condition for the attraction of investment”.

County	Total budget	Private	Implementation period
Alytus	€82.4 mln	€35.6 mln	2004-2006
Kaunas	Not included		
Klaipeda	€2.2 mln	No indication	2003-2006
Marijampole	€1.7 mln	€0.5 mln	2005-2007
Panevezys	€3.1 mln	€0.1 mln	2004-2006
Siauliai	€69.3 mln	€32.1 mln	2004-2006
Taurage	€0.3 mln	No indication	2004-2006
Telsiai	€12.2 mln	€5.6 mln	2004-2006
Utena	€5.7 mln	€1.5 mln	2004-2010
Vilnius	Not included		

72. Hence we can see which specific projects have received priority approval, and in those plans that list budget allocations which projects and municipalities are getting more support. Some projects are very long term, e.g. Utena City is to get a €9.6 mln project to renovate water supply in the city by 2020, €1.9 mln is committed from the national budget. Others are more immediate, for example the largest commitment for long-term local plan preparation in Utena County is to Zarasai, for which the national government pledged €188 thsd by 2005. Hence the first advantage of these plans is the increase in the transparency of data on planned projects. Clearly even the shortest time horizon projects imply commitments that may be broken by a change of government. However, the second advantage of the plans is that they create a political impediment to cuts. The benefits to the state from creating a more credible commitment are that the other partners (local authorities, businesses and the EU) are more willing to contribute to achievement of the goal. The government can increase the credibility of its commitment by increasing the political penalties for renegeing. The Lithuanian government does this by advertising its plans widely.

73. As an example of the role of the county plans, Table 8 above illustrates some of the variety in provision for innovation in business across the ten countries. Hence Alytus Country planned the largest expenditures on innovation in industry. Kaunas and Vilnius Counties did not mention innovation at all in their development plans. Of the six counties which gave a breakdown, all except Panevezys expected to use EU structural funds to induce large expenditures from private business.

The role of employers, chambers of commerce and tripartism

74. The Lithuanian Business Employers' Confederation has an ongoing dialogue with national government. It sends proposals to the government on various business related issues. Examples from 2004 included a draft amendment to the privatisation law, property taxation, and the minimum wage. Similarly the Lithuanian Confederation of Industrialists makes both public announcements of its opinion on policy issues and direct appeals to the national government. Recent issues addressed by the Confederation include introduction of the Euro, savings compensation and EU entry. The Lithuanian Chamber of Commerce is perhaps less transparently politically active, although it has many contacts with government. It was active in discussion with all political parties before the 2004 parliamentary election. It has also signed a cooperation agreement with the Minister for Social Security and Labour.

75. The Tripartite Council of Lithuania, under the auspices of the Ministry of Social Security and Labour, contains representatives of three union confederations, two industry confederations and five ministries. The Council's discussions have concentrated on fields related to taxation, social insurance,

employment law, enterprise law, EU membership and unemployment. The Lithuanian Labour Exchange is responsible for the Tripartite Commission. Tripartite commissions, functioning on a voluntary basis, are also set up at the regional labour exchanges for the consideration of employment issues. The commissions consist of representatives of trade unions, employers and public authorities.

Partnerships, local or regional development agencies, local initiatives

76. There are no local or regional development agencies in Lithuania. County administrations and local authorities have their own development departments to manage economic development in their jurisdiction. Counties also have regional development councils. Local initiatives for economic development are most evident in the capital, Vilnius. Here efforts have been made to ease bureaucratic obstacles for investors, to improve the transport infrastructure in the city and to direct development around a geographical cluster away from the historical centre. Another tool, used in Lithuania more frequently outside the major cities, is tax abatement for property taxes.

2.4 Regional policy and structural funds

77. It might be thought that regional policy is an area where we may find more in the way of bottom-up initiatives. However, in practice, the evidence is rather mixed.

Estonia

78. Regional policy in Estonia is the responsibility of the Ministry of the Interior which has a Sub-ministry of Regional Affairs with its own minister. The Ministry is responsible both for spatial planning and for regional development. The Ministry has worked out a national plan: *Long-term National Spatial Plan - Estonia 2010*. Counties have to prepare county strategies in co-operation with municipalities. Since the counties are part of central government this seems a rather top-down process.

79. Estonian regional development policy is based the Estonian Regional Development Strategy adopted in 1999. The strategy aims at:

- bringing living standards (average income per household) in all counties to at least 75% of the level of the Estonian average.
- unemployment rates for all counties at no more than 35% above the Estonian average.

80. In 2000 – 2003 several regional development programmes were implemented. These included programmes for the Islands, industrial regions and agricultural regions; local initiative centre networks and cross-border cooperation programmes. The projects have been aimed mainly at developing human resources, at improving the business environment and at improving local infrastructure.

81. The targets for 2003 have not been fully met. In 2003 living standards in Ida-Viru and Jõgeva counties remained below 75% of the Estonian average and the unemployment rates for Ida-Viru (82%), Jõgeva (58%) and Põlva (37%) counties exceeded Estonia's average unemployment rate by more than 35%.

Latvia

82. During the period from 1996 to 2002 regional affairs were the responsibility of a variety of institutions. Following a review undertaken in 2001⁴, which reported the inconsistent use of basic terms such as “regional policy” and “regional development” and concluded that Latvia lacked a co-ordinated and efficient regional policy, responsibility for regional affairs was consolidated in 2002 in a Regional Policy and Planning Board within the Finance Ministry. The Board drafted the Regional Development Law (adopted on 21 March 2002) and the Spatial Planning Law (adopted on 22 May 2002) as well as the first draft of the National Development Plan (NDP) which was to be the basis for the Latvian Single Programming Document (SPD). In February 2003 the functions and tasks of the Regional Policy and Planning Board were transferred to the Ministry of Regional Development and Local Government where they remain today.

83. Regional policy in Latvia has two components: one concerns regional planning and the other concerns measures to combat regional disparities.

Planning

84. The Regional Development Law of 2002 created five planning regions which correspond to Latvia’s traditional regions and also reasonably closely to Latvia’s five statistical regions at NUTS III level. The planning regions and their constituent local governments are:

- Izkurzeme – cities of Liepāja, Ventspils and local governments of Kuldīga, Liepāja, Saldus, Talsi and Ventspils districts;
- Latgale – cities of Daugavpils, Rēzekne and local governments of Balvi, Daugavpils, Krāslava, Ludza, Preiļi, and Rēzekne districts;
- Rīga – cities of Rīga, Jūrmala and local governments of Linbaži, Ogre, Rīga and Tukums districts;
- Vidzeme – local governments of Alūksne, Cēsis, Gulbene, Madona, Valka and Valmiera districts;
- Zemgale – city of Jelgava and local governments of Aizkraukle, Bauska, Dobele, Jelgava and Jēkabpils districts.

85. Each planning region has a Regional Development Agency and these agencies have prepared Regional Development Plans and other local planning documents, often with the technical assistance of foreign advisers. The problem with the Development Plans and the Development Agencies is that there is no explicit mechanism for implementation, nor for incorporating plans into mechanisms that do implement real policy, e.g. the structural funds. An inspection of the Latvian SPD reveals rather minimal attention to the regions and no role for the Regional Development Agencies.

Regional development

86. Regional development policy in the sense of addressing regional disparities, promoting regional economic activity and employment was initiated with the law “On Specially Assisted Territories” and the

⁴ ‘Regional Development Policy and its Institutional Structure’, Ministry of Special Assignment on Public Administration Reform.

creation of the Regional Fund in 1998. The Regional Fund provides support and facilitates entrepreneurial activities in designated assisted territories approved by the Cabinet of Ministers.

87. Support is mainly in the form of interest rate subsidies for businesses. There is also co-financing for business training projects and for municipalities to develop business support infrastructure (e.g. tourism and business support centres).

88. Average annual allocations from the Regional Fund have been approximately LVL 1 million (approximately 1.4 million euro). So this is quite a small programme. However, it is claimed by the government that during the six years of its operation (1998-2003) 3000 new permanent and 3500 temporary jobs have been created and 3900 jobs have been preserved, including in 2003 793 new jobs, 563 temporary jobs and over 800 jobs preserved⁵.

89. Nine projects were also implemented under the Phare 2000 national programmes “Economic and Social Cohesion Measures in Latgale” and “Economic and Social Cohesion Measures in Zemgale”.

90. The programme has continued with the state aid programme “Development of Business (Entrepreneurial) Activity in Specially Assisted Territories” that complies with SPD requirements.

91. As before support, is available for enterprises registered and operating in specially assisted territories in the form of an interest rate subsidy (loans and credits to enterprises) or as an initial investment in fixed assets. Only small and medium-sized enterprises are eligible for assistance.

Lithuania

92. Regional policy (as well as local authorities) come under the responsibility of the Ministry of Interior. This is a result of a reorganisation that abolished the Ministry of Public Administration and Local government several years ago. That ministry seems to have been moved more or less wholesale to the Ministry of Interior, which now has a Department of Public Administration. This ministry includes a Local Government Policy Division that deals with LA matters, and a Department of Regional Policy, that deals with development coordination and management issues. It should be noted that, the Lithuanian Ministry of Finance wields a lot of power in regional and local government matters through its control of the budget. In particular the Finance Ministry's Budget Department contains a Regional Development and Local Authority Budgets Division.

93. Regional policy seems to be rather integrated in Lithuania. Its goals, content and objectives are defined by the Law on Regional Development (December 2002). The main goal is to reduce social and economic disparities both between and within regions and to promote even and sustainable development of all the national territories. The regional dimension integrated into all general national sectoral programmes and in the measures of the Lithuanian SPD.

94. Policy is shaped and implemented through the development and implementation of:

- the State Long-Term Development Strategy and the Single Programming Document of Lithuania for 2004-2006;
- the General Plan of the Territory of the Republic of Lithuania;

⁵ Latvian NAPE September 2004 pp 60-61.

- strategies and programmes that integrate regional policy at the level of individual economic sectors;
- general plans of designated region (county) development and administrative units;
- municipal development programmes;
- targeted integrated state regional development programmes aiming to solving acute regional problems; and
- regional and local development initiatives.

95. Instruments take the form of state support for projects implemented in critical areas and in regions facing specific regional and local problems in specific economic sectors. Here of course Lithuania has one major specific regional problem – the Ignalina Nuclear Power Plant.

96. Goals of the Regional Development Programme include:

- creation conditions for the development of a regional planning system in Lithuania.
- provision of opportunities for regions and municipalities to receive the EU structural support for projects; and
- preparation for the implementation of the EU Communities Initiative Programme INTERREG III.

97. Thus there is an emphasis on assisting county administrations in drafting or updating development plans and identifying the most important regional problems, including problems of unemployment, and also developing a regional development vision. Regions and municipalities in critical areas have also been assisted in preparing for the successful exploitation of EU Structural Funds support.

98. At the level of direct regional measures the EU PHARE 2000 Economic and Social Cohesion Programme supported 265 projects with budgets totaling 22 million euro in three target regions of the country (Klaipėda-Taurage, Utena and Marijampole Counties) as of end 2003.

99. PHARE support has been aimed at two priorities: business development and human resources development using the Business Development Fund and the Human Resources Development Fund as instruments. Measures financed by the Business Development Fund promoted the creation of new companies, the development of business competitiveness and new job creation. Measures financed by the Human Resources Development Fund focused primarily on the training and retraining of vulnerable groups – youth, the unemployed, single mothers, pre-retirement age people. An important element has been development of training programmes, training of teachers and instructors and purchase of training equipment.

100. Five municipalities (Mazeikiai, Lazdijai, Akmenė, Pasvalis and Druskininkai) were identified as having special problems and joint implementation plans for addressing social and economic problems have been developed for these municipalities. Socioeconomic development measures included measures aimed at:

- developing local infrastructure;

- increasing the attractiveness of the municipalities for investment; and
- increasing labour force mobility.

3. INSTITUTIONAL ASPECTS OF LABOUR MARKET POLICY

3.1 Introduction

101. Labour market policy is an area in which the structure of policy has been defined very much at the top – and in this case the top means not just the central governments in the Baltic states but Brussels. As part of the EU accession process all the candidate countries, including the Baltic states, were committed to implementing the European Employment Strategy (EES) and have been participating in the process since 1999. The ‘new’ EES has three ‘overarching objectives’;

- Full employment.
- Improving quality and productivity at work.
- Strengthening social cohesion and inclusion.

102. These overarching objectives are implemented through a National Action Plans for Employment (NAPE) for each member state which, within a framework of ten guidelines, should contain the following elements:

- an assessment of the current situation;
- a description and evaluation of measures undertaken in the previous year;
- an elaboration of measures proposed for the future; and
- a definition of expected outcomes and targets.

103. The Baltic states have produced several NAPEs in previous years without participating fully in the EES as member states. Employment policy has also been shaped by Joint Assessment Papers developed and agreed at governmental level with the European Commission. However in 2004 the Baltic states participated for the first time in the full process.

3.2 Overview by country

Estonia

104. Institutional flexibility (labour market regulations) in Estonia is demonstrated by a relatively open wage setting process, relatively weak but increasingly developed social dialogue, relatively low employment protection measures, low unemployment benefits, and a small impact of active labour market policy (Vesilind and Rell, 2000; Philips, 2001; Freytag, 2002; OECD, 2003). A liberal wage policy has been a feature of Estonia from the beginning of transition. Government intervention in the wage policy of the business sector is minimal, being limited to the establishment of minimum wages and fulfilment of obligations defined in labour legislation. The latter consists mainly in providing internationally acknowledged rights to workers. Salaries in the public sector are often linked to pay in the business sector, which has increased the attractiveness and competitiveness of jobs in the public sector (Antila and Ylöstalo, 2003).

105. A big problem for the Estonian labour market is a mismatch between what is offered by the educational system and labour market demand. The problem is especially acute in vocational education where many vocational school graduates remain unemployed after graduation (Berde *et al*, 1999, 210; Venesaar *et al*, 2001). In recent years, this has also become a problem for young people with higher education who have not sufficient employment (jobs) in the economy. This may explain why for instance four out of five unemployed persons accept jobs that require a lower educational level than they actually have (Eesti inimarengu aruanne, 2002, 34).

106. Workforce mobility is revealed primarily in a fast circulation of labour, including movement within, out of and into the labour market. Labour circulation in Estonia appears to increase in periods of instability (in contrast to western countries), when enterprises reduce the number of jobs or restructuring occurs, and many workers have to change employment. This indicates that employers rather than workers drive labour market mobility in Estonia (Eesti Inimarengu aruanne, 2002). The role of employers in influencing the labour market movements is also indicated by the reasons given by workers for losing employment – the main reasons given are liquidation, bankruptcy or redundancy (Estonian Labour Force Survey, 2001) as compared with less than 5% of workers who left their last job because they were not satisfied with the wages, work or working conditions.

107. The flexibility of the labour market and the mobility of the workforce are determined also by the ability of the enterprises to leave the market, which means the existence of a bankruptcy law and the absence of subsidies for insolvent enterprises (Freytag, 2002). Some analyses have indicated that high employment flows in enterprises are a result of fast reforms in Estonia compared to other transition economies (e.g. Slovenia) (Faggio and Konings, 1999; Haltiwanger and Vodopivec, 2001). Employment mobility in Estonia is comparable with that of the USA and UK (Davis and Haltiwanger, 1999).

108. The Ministry of Social Affairs is responsible for the development of employment policy in Estonia. The principal policy documents prepared in 2004 were the Labour Market Strategy in May 2004 and the Estonian NAPE in August 2004.

109. Active labour market policy is implemented by the Labour Market Board and its sixteen public employment service branch offices that are located in every county plus Tallinn. The capacity of the Estonian public employment service is regarded as limited (OECD, 2003) with weak connections with employers, small impact of services, and lack of capacity for training workers for many new professions. That may be why labour market policy has had modest results despite the implementation of a number of new programmes in recent years (Ministry of Social Affairs, 2003). The result has been a relatively low average open unemployment rate because of low unemployment benefit – below 10% of average wages in 2001, a short period of benefit payments – 6-9 months; modest help from employment offices in job-seeking and training and the weak role of social partners. There is little interest in registering as unemployed with the number of registered unemployed at between 50% to 75% of the number of unemployed according to the labour force survey.

Modernising the public employment service

110. The work of the Labour Market Board includes providing the unemployed with social protection and employment services; processing and analysing the job-seekers data; cooperating with State institutions, local governments and workers and trade unions and associations. Attention has been repeatedly drawn to the need to increase the human resources and administrative capacity of the public employment service.

111. The capacity problems of the public employment service in Estonia have been repeatedly pointed out as crucial obstacles to meeting the targets of labour market policy, e.g. in the Labour Market Strategy,

in the Wim Kok report “Jobs, Jobs, Jobs” and in the JAP Success Report 2003. There is a need to train staff and improve the quality and efficiency of the services offered. It is proposed to use ESF projects in to remedy these problems.

112. In 2005-2006, it is planned to completely reorganise the work of public employment service. The aim is to provide clients with forms of assistance tailored to their needs and to improve cooperation with local employers. The general principles for the new service are established in the Estonian Labour Market Strategy. When clients turn to the public employment service, they will be interviewed in order to identify the kind of assistance they need most. Depending on the assistance needed, they will be directed to the career and counselling centre or to the case management centre. The career and counselling centre deals mainly with clients who are regarded as ready to compete in the open labour market.

113. Clients who require more assistance and support and/or integrated services, as well as people who have not found a job through the career and counselling centre within 4 months will be directed to the case manager. The task of the case manager is to assess the client's abilities and problems together with the client and together prepare a personalised action plan for finding a job. It is also essential to involve the services of other systems and integrate them with employment services.

114. Currently, one problem is the lack of unity in the provision of labour market measures: State Unemployment Allowance and active labour market measures are administrated by the Labour Market Board offices, but Unemployment Insurance Benefit is provided by the Unemployment Insurance Fund. This complicates the task of combining different measures and requires double resources.

Latvia

115. The formal basis of Latvian labour market institutions rest with a series of legislative measures aimed at bringing the rights and obligations of Latvian labour market participants in line with EU requirements. These include a new Labour Law and a Law on Labour Protection both adopted in 2002. Enforcement of labour legislation as well as responsibility for health and safety is in the hands of the State Labour Inspectorate. A Law on Labour Disputes was adopted in 2003, and there is now a tripartite body to appoint public conciliators.

116. A reformed pension system has been created with three tiers, each following the defined-contribution principle. The first tier was reformed in 1995, the third tier legislated in 1998, and the second tier in 2001. Unemployment insurance was introduced in 1995 and modified to offer less generous benefits in 1999. Insurance against occupational accidents and diseases was introduced in 1997.

117. Although an EU and ILO compliant labour market framework apparently has been created in Latvia, employers frequently ignore the legislation and regulations. Thus there are many people who work without employment contracts, and pay regulations and provisions are also frequently violated. There remains also the widespread practice of envelope wages whereby workers have an employment contract at the minimum wage but their pay is supplemented by untaxed cash in the ‘envelope’. The resources of the State Labour Inspectorate and other agencies such as the State Revenue Service have been insufficient to make a serious dent in the prevalence of these practices.

118. Wage setting in the private sector is largely decentralised with a minimum of intervention by the state. Where there are bilateral agreements, either at the enterprise or sectoral level, non-union employees are also entitled to the agreed wage. The state also defines the minimum wage.

119. Other than the NAPE and the other documents that are part of the implementation of the EES Latvia does not have an employment or labour market policy document as such. The Ministry of Welfare is the government department most closely involved with labour market and employment issues. Other

involved departments include the Economics Ministry, the Ministry for Regional Development and Local Government and the Ministry of Education and Science.

120. The main institution implementing labour market measures is the State Employment Agency (SEA) – in particular the SEA is responsible for an array of active labour market measures such as occupational training, retraining and increasing the qualifications of the unemployed; paid temporary public works; measures to increase competitiveness (job clubs) and measures aimed at specific groups such as pre-retirement age persons or unemployed people with disabilities. The SEA also acts as an employment placing agency for the registered unemployed.

121. In addition to the SEA the Professional Career Counselling Centre (PCCC) is responsible for implementing policies aimed at preventing unemployment by providing career counselling and vocational guidance services. The PCCC provides free-of-charge vocational guidance to individuals; maintaining an up-to-date methodological basis for providing career counselling services tailored for specific target groups; it provides access to information about education opportunities. Also the PCCC offers consultation services for a fee to businesses in areas such as career counselling, human resource management, recruitment, retraining, psychological support.

Local employment initiatives

122. Representatives of SEA branches meet regularly with local municipalities. In 2003, as a result of the joint activities of local SEA and municipalities, local employment promotion action plans were developed for 65 towns, 14 amalgamated municipalities (*novadi*) and 462 rural municipalities.

123. In order to strengthen the cooperation of governmental and municipal institutions and non-governmental institutions in coordinating and discussing their interests in issues concerning employment policy implementation, the State Employment Agency is in the process of creating Advisory Councils in all branches of the SEA.

Case study: Daugavpils

The city council development department

124. Daugavpils is Latvia's second largest city located in Latvia's poorest region, Latgale. It is host to problematic enterprises and to problematic workers.

125. The city development department has been working on a "Development Plan of Daugavpils" created for the next 7 years (2005-2012). The plan concerns the creation of new enterprises and new working places, and there is a section devoted to employment and unemployment issues.

126. There is also a yearly document produced by the development department based on data gathered from various industries and firms in Daugavpils, where future investment plans, new projects, planned number of employees by enterprises, etc., are covered. This document is more like a report than a plan since it does not contain proposals for directed actions or measures that will or should be taken.

127. In some instances the development department of the City Council creates a working group consisting of representatives from a problematic enterprise (for example recently: Dauer, Lokomotive which was proposing large lay-offs), from the development department, from trade unions, together with representatives of the SEA. The idea is to create an orderly and managed lay-off process.

128. There is an agreement with SEA on joint actions. The institutions agree between themselves on what is necessary to be done from the other party and what measures the other party is obliged to take (e.g. the number of people that have to go through certain educational trainings, voluntary work events, etc.).

Employment planning in Daugavpils and Daugavpils district

129. A typical employment promotion plan is usually 9-11 pages long and is created on the basis of framework provided by the central SEA office in Riga. A separate plan is created for each *pagasts* and also for Daugavpils city. The process usually starts in November/December with meetings between the local SEA branch and the municipality, during which mutual liabilities among the parties and well as liabilities to the unemployed people are discussed. The plans for the *pagasti* are gathered together and signed by district mayor and the plan for Daugavpils is signed by city mayor.

130. The procedure for employment plans creation is uniform throughout the country and after such plans are created throughout Latvia they are sent to Riga for review and approval, where they are also evaluated in terms of what can be actually done taking into account the financial constraints and resources available.

131. The development plan prepared by the Economic Development Department at the City Council is separate from the SEA supported employment plan. Therefore, the employment issues touched upon in the two plans may be different, and may have different visions and perspectives.

Lithuania

132. In Lithuania employment policy is the sphere of the Ministry of Social Security and Labour which was responsible for coordinating the working group that prepared Lithuania's NAPE.

Employment policy design

133. Lithuanian employment policy, aims to be integrated with the main programming documents such as the State Long-term Development Strategy, the Long-term Economic Development Strategy, the General Plan of the Territory of the Republic of Lithuania, the Convergence Programme of Lithuania and the Single Programming Document.

134. The Employment Increase Programme of the Republic of Lithuania for 2001-2004 has been the main strategic document on the employment policy and is an inter-institutional programme developed and implemented in cooperation of several institutions – the Ministry of Social Security and Labour, the Ministry of Economy, the Ministry of Finance and the Ministry of Education and Science.

135. Implementation of the Employment Increase Programme is coordinated by the Ministry of Social Security and Labour and other ministries participating in the Programme must coordinate their common activities with it. In the process of coordination the parties agree on common goals, on who implements specific objectives and takes specific measures.

136. The Employment Increase Programme for 2001-2004 has been developed by an interagency workgroup made up of the representatives of the ministries whose policy and programmes have the biggest impact on employment. The working group was headed by the Ministry of Social Security and Labour as the main institution dealing with employment policy issues at the national level.

137. Key implementing institutions the Lithuanian Labour Exchange and the Lithuanian Labour Market Training Authority.

138. From 2004 the NAPE replaces the Employment Increase Programme.

Best practices in employment policy

139. The Lithuanian NAPE identifies several initiatives that it regards as representing best practice. These include: Local Employment Initiatives; Support for the Long-term Unemployed in Creating Local Networks; and unemployment prevention measures. These are briefly discussed.

Local Employment Initiatives

140. These are projects to create subsidised jobs in the highest unemployment areas involving social partners. The projects are implemented in municipalities and neighbourhoods where the unemployment rate is 1.5 times higher than the national average or where such an unemployment rate is likely to occur due to mass lay-offs.

141. Open tenders are announced for proposals. The beneficiary which is a small or medium-sized business must cover at least 35% of the project expenditures. The maximum state support to one project is 100 thousand euros and to create one job – 5.2 thousand euros. The project implementer undertakes to employ unemployed people with priority given to persons who are the most vulnerable on the labour market (long-term unemployed, people with disabilities, etc.) and to maintain such jobs for three years.

142. Over the period 2001-2003 the programme has created 1.24 thousand new jobs. Their multiplication effect is very important – research shows that for every 10 jobs created by the project directly one additional job was created. Also the projects appear to have been quite profitable. Other benefits include:

- Involvement of the social partners.
- Project implementers and administrators attend special training courses where they are given knowledge on the procedures of project implementation, funds management, monitoring and control and report preparation.
- The projects are good practice in preparing for the exploitation of the EU Structural Funds.

Support for the Long-Term Unemployed in Creating Local Networks

143. This is a project implemented by the Lithuanian Labour Market Training Authority in cooperation with partners from the Netherlands – Nehem International and Huesken & De Pree Consultancy. The project offers support for the long-term unemployed in creating local networks in four regions of Lithuania (Klaipeda, Taurage, Panevezys and Alytus).

144. Goals of the project:

- to create a methodology of returning the long-term unemployed to the labour market (intermediation services when getting employed);
- to train the consultants of local divisions of the Lithuanian Labour Market Training Authority to work with this methodology;
- to create a cooperation network on the local and regional levels between agencies interested in solving the problems of long-term unemployment;

- to test the developed methodology and present it to other organisations in all regions.

145. A methodology of returning the long-term unemployed to the labour market was developed – the *Work Opportunities Programme* – with a view to training the unemployed to enable them to eliminate psychological and social barriers that preventing from the participation in the labour market. This programme applies to people who are looking for their place on the labour market after a long period of unemployment. Training was conducted in groups based on mutual interaction regularities. Communication with other group members (also long-term unemployment) under the supervision of a qualified psychologist helps to motivate people in shaping their active social position and solving difficulties in life.

146. The Work Opportunities Programme consists of 4 stages. The first stage “What I Want?” was designed with a view to helping the participants to develop their desires, objectives and values. During the second stage “What I Can?” the participants were encouraged to discover their capacities, strong sides, to evaluate their current skills that can contribute to the realisation of their desires. During the third stage “Is It Possible?” the organisers tried to help the participants to assess their real prospects – desires, personal and situational opportunities. During the fourth stage, “The Action Plan”, the participants were trained to compile a real action plan according to which they could take efficient action. At the end of the Programme, examples of successful and unsuccessful employment efforts and the effectiveness of the action plans are analysed.

147. During the project implementation the organizers activated various institutions whose representatives were delegated and involved into the creation of local networks. *Coordination Committees* and *Initiative Workgroups* comprising the representatives of municipalities, the Chambers of Commerce, Industry and Crafts, local labour exchanges, trade unions, educational institutions, private structures, industrialists’ associations, non-governmental organisations (NGOs), the media, lawyers and other organisations were formed. Council members took active part in meetings and training courses with the long-term unemployed, presented their institutions, answered questions, helped to get orientation on the labour market and provided information on job vacancies. Council meetings were held regularly, and psychologists and consultants reported about the course of the training, some problems, the customer’s proposals and requests; they also discussed how they managed to employ the long-term unemployed participants and refer them to training courses.

148. *Work Opportunities Centres* were established under the Labour Market Training and Counselling Authorities in Alytus, Panevėžys and Klaipėda. They have become a place of vocational information, guidance and counselling measures in working with the long-term unemployed, social partners and the local community. In the Work Opportunities Centres participants had and will have an opportunity to use computers, read the press, search for the information they need when looking for a job on the Internet.

149. Of the 250 long-term unemployed groups that have completed the Work Opportunities Programme during the project 50% got a job, and of those 78% found a permanent job, 16% were employed in public works, and 5% started their won business.

Unemployment prevention measures

150. In a market economy reorganisation, liquidation or bankruptcy of a company is a common phenomenon resulting in mass lay-offs. Their regulation and prevention is one of the goals of the Lithuanian Labour Exchange.

151. Lists of companies at risk have been compiled in the regions (cases of partial employment, reduction of the staff number, etc.). Local labour exchanges in the country undertake information and

counselling work with the employees who have received a dismissal notice from their employers about their dismissal. This work is carried out in provisional labour exchange divisions (mini labour exchanges) established at insolvent companies or those intending to dismiss employees.

152. Services provided by a mini labour exchange:

- information on job vacancies;
- individual and group counselling;
- information about active labour market measures;
- to answer questions.

153. The mini labour exchange may organise visits to other (local) companies or organise visits from other companies to provide opportunities earning about other options.

154. In cooperation with the Ministry of Labour of Denmark, a *Mass Lay-Off Handbook* was developed and posted on the web-site of the Lithuanian Labour Exchange [www.ldb.lt/atleidimai].

3.3 Good governance and tripartite co-operation

Estonia

155. The Estonian NAPE was prepared under the guidance of the Labour Market Department of the Ministry of Social Affairs. Other departments of the Ministry, as well as the Ministry of Education and Research, the Ministry of Internal Affairs the Ministry of Economic Affairs and Communications, the Labour Market Board, the Labour Inspectorate and the social partners also contributed to the NAPE.

Social partnership

156. Coverage of the work force by trade unions and employers associations is rather low in Estonia although it is on the rise. As of 1 January 2004, trade unions covered 48,467 workers, which represent about 7.6% of the workforce and about 8.5% of the employed. The number of companies with trade union representation grew by 24 to 567 in 2003. The Estonian Employers Confederation (ETTK) unites approximately 1,500 companies that employ 150,000 workers (approximately 35% of those employed in the private sector).

157. Estonia's JAP 2001 emphasised the need to develop an institutional framework for including social partners in policy-making and progress has been made. The PHARE Twinning project *Social Dialogue in Estonia* that was carried out from autumn 2002 to spring 2004 contributed to the development of social dialogue and social partnership and the government has allocated 1.9 million kroons (just over 120000euro) over the period 2004-2006 to support the promotion of social dialogue

158. The most important tripartite institutions dealing with labour market issues directly or indirectly are:

- the Social and Economic Council;
- the National Employment Council founded in 2003 for supporting and complementing the work of Regional Employment Councils;

- the Council of the Unemployment Insurance Fund, comprising representatives;
- the Working Environment Council;
- the Vocational Council, which aims to coordinate vocational education reforms; and
- the Adult Education Council.

159. The most important of the tripartite councils is the Social and Economic Council which was created in 1999. The Council gives representatives of employers and workers the opportunity to be involved in the design and implementation of national economic and social policies. It is aimed at an equilibrium between the requirements of economic development and those of social protection. The Council's main function is to advise the government and local authorities on social and economic issues. All three parties have equal representation (6+6+6) in the Council and are completely free to nominate their members. The government nominates five independent experts (researchers, scientists) and a chairperson of the Council. There is also the option to invite independent experts from outside the Council. Issues discussed have included: free movement of labour, minimum wages, lifelong learning and adult education, tax policy etc.

160. The National Employment Council has the following responsibilities: uniting labour market parties, collecting the opinions of the Ministry of Social Affairs, the Ministry of Education and Research and the Ministry of Economic Affairs and Communications; and advising the government on labour market issues. It also coordinates the work of the Regional Employment Councils. The task of Regional Employment Councils is to advise the public employment service at local level on the preparation of County Employment Strategies and on the provision of active labour market measures.

161. The role of the social partners has been especially important in promoting development of human capital and life-long learning. The representatives of both employers and workers contribute to the development of the professional qualifications system through Vocational Councils. In 2002, ETTK started an extensive survey of labour force needs in cooperation with the Ministry of Social Affairs. The survey aimed at forecasting the demand for skilled labour in the private sector in 2003-2005. 450 medium and large enterprises took part in the survey, and labour market need was identified in 13 sectors.

162. In 2003, EAKL and ETTK expressed their opinions on the use of the EU Structural Funds for developing human resources and improving social dialogue. They also stressed the need to involve the social partners in the allocation of structural funds.

163. Two agreements concluded in the course of social dialogue in Estonia directly support the implementation of the European Employment Guideline Making Work Pay through Incentives to Enhance Work Attractiveness: One was an agreement was concluded in 2001 for setting the level of the minimum wage which aims at achieving a minimum wage of at least 41% of the average monthly gross wage in Estonia by 1 January 2008 and the second is a tripartite agreement to raise the tax-free income threshold. The agreement aims at a gradual rise in tax-free income threshold to 2,000 kroons (128 euro) by 2006. Both EAKL and ETTK are committed to reducing the prevalence of undeclared work and there is cooperation with the Labour Inspectorate and the Tax and Customs Board both at both branch and central levels.

Latvia

164. The NAPE is developed by a steering group which includes:

- representatives of public institutions (Ministry of Welfare, Ministry of Education and Science, Ministry of Agriculture, Ministry of Regional Development and Local Governments, State Employment Agency). If necessary, the development of the NAPE is assisted by the Ministry of Finance, Ministry of Justice and other ministries.
- social partners (Latvian Free Trade Union Confederation and Latvian Employers' Confederation).

165. During the development process of the NAPE, municipalities, regional development agencies, councils and other bodies may be asked to provide proposals and information.

166. Monitoring of the NAPE is the responsibility of the Ministry of Economics and is implemented on a semi-annual basis. The institutions assigned various responsibilities for measures submit information on their progress on a semi-annual and annual basis. The social partners also provide information on their activities in the field of promoting of employment. The monitoring report the employment and unemployment conditions in the country and summarises the performance of public institutions and social partners in implementing the planned measures or highlights shortcomings in achieving the anticipated results and their detailed explanations (insufficient funding, initiative or activity, impediments in the legal framework, etc.).

Social partnership

167. The most important employment policy issues are reviewed by the National Tripartite Cooperation Council (TCCC) which consists of representatives from government, employers and trade unions. Employers and the employees are represented by the two intersectoral organisations, Confederation of Latvian Employers (LDDK) and Free Trade Unions' Federation of Latvia (LBAS) respectively. The government side includes representatives from Ministries of Welfare, Economics, Health, Finance, Regional Development and Municipalities, and Justice.

168. The Council is the primary means ensuring social partners' participation in the legislative process concerning the issues of relevance to the social partners. The objectives of the Council are "to ensure and promote cooperation on national level among the government, the employers, and the employees (trade unions) in order to achieve solving of the issues relating to socio-economic development that would promote consent and be in accordance with the interests of society and government, by developing and implementing strategies, programmes and normative acts affecting social and economic issues, which would guarantee social stability and growth in welfare, as well as heighten the social partners' co-responsibility for the decisions made and their enforcement."

169. The council is made up of seven representatives from each participant. The government representatives are nominated by the Cabinet of Ministers, and the representatives of the social partners are elected by the relevant decision-making institutions of the respective organisations; representatives can be replaced by the participants at any time. At least five representatives from each participant are required to form a quorum; decisions are reached by agreement, and are binding to all parties. The Council should meet whenever is necessary, but no less frequently than once every two months.

170. During the EU accession process virtually every change or project in legislative process touching upon issues relevant for employers and employees has been reviewed in NTCC. The most recurring themes are job safety, minimum wage, the pension system, and healthcare.

171. The outputs of the work of NTCC are the proposals and, occasionally, objections, submitted to Ministries or Commissions that prepare legislative projects. The result is improved or adjusted legislation

that is of concern to employers and workers, and occasionally, the entire population. However, the NTCC itself is not involved with the implementation of legislative requirements. Thus, it can be rather regarded as an informative body bringing the detailed information to the intersectoral organisations, which can then promote compliance among their members.

172. The Ministry of Regional Development has recently proposed to create regional tripartite councils. The aim is to further develop partnership between the SEA, trade unions and employers organisations at the local level.

Lithuania

173. The National Action Plan was drafted by an interagency committee consisting of representatives of the Ministry of Social Security and Labour, the Ministry of Finance, the Ministry of Transport and Communications, the Ministry of Education and Science, the Ministry of Economy, the Ministry of the Interior, the Ministry of Agriculture, the Department of National Minorities and Lithuanians Living Abroad under the Government of the Republic of Lithuania, the Department of Statistics, the Lithuanian Labour Exchange, the Lithuanian Labour Market Training Authority and the Labour and Social Research Institute – secretaries of the Ministries, directors or deputy directors of the agencies.

Social partnership

174. In Lithuania the tripartite system is based partly on agreements between the government, employers' organisations and trade unions and partly on laws covering the provision of the tripartite collaboration (e.g. the Law on the Support for the Unemployed, the Law on Vocational Training, etc.). The Labour Code of the Republic of Lithuania in force since 1 January 2003 sets out the social partnership system consisting of the Tripartite Council of the Republic of Lithuania and other tripartite and bipartite councils (commissions, committees) formed in accordance with the procedure laid down in the laws or collective agreements.

175. Tripartite collaboration in Lithuania has been important in issues relating to unemployment, work pay, social guarantees for employees, safety at work and health care for employees and other issues. The drafting and discussion of the Labour Code has benefited from social dialogue.

176. The Tripartite Council of the Republic of Lithuania has been functioning since 1995. It consists of 15 members – 5 representatives from each of the social partners. The interests of trade unions are represented by the Lithuanian Trade Unions' Confederation, the Lithuanian Labour Federation and the Lithuanian Trade Union "Solidarumas". Employers are represented the Lithuanian Confederation of Industrialists and the Lithuanian Confederation of Business Employers. The government is represented by the Ministry of Social Security and Labour, the Ministry of Justice, the Ministry of Economy, the Secretary of the Ministry of Agriculture and the Deputy Minister of Finance.

Social partnership in the activities of employment agencies

177. Representatives of employers and employees are encouraged to cooperate in organising, performing and controlling the activity of employment agencies at both national and local/regional levels.

178. A Tripartite Commission under the State Labour Exchange and 46 local tripartite commissions under each local labour exchange have been established with the specific aim of dealing with the issues relating to the labour market and the implementation of the labour market policy measures and services.

179. The Tripartite Commission under the Lithuanian Labour Exchange consists of 15 members. Ministries, Lithuanian trade unions organisations and Lithuanian organisations of industrialists and

business employers represented at the Tripartite Council of the Republic of Lithuania delegate their representatives to it. The Lithuanian Association of Local Authorities nominates observer.

180. The local Tripartite commissions are established according to the principle of equal tripartite partnership and consist of 6 or 9 members depending on the area of the region served by the local labour exchange and the number of social partners located within the region who are willing to participate in the work of the tripartite commission.

181. The local commissions have delegates from local associations of trade unions and employers – according to the mutual agreement between the local organisations of Lithuanian industrialists and business employers. Representatives of the state institutions are appointed by County Governors and directors of local training authorities, and representatives of municipalities (neighbourhoods) – by municipalities. Besides, local private employment intermediation companies delegate 1 representative each to tripartite commissions as observers by mutual agreement. Members of the tripartite commissions perform their functions on a voluntary basis and are accountable to the organisations and institutions nominating them. Decisions are of an advisory character.

4. SOME RECENT INSTITUTIONAL REFORMS

Institutional reform across a broad front has been ongoing in all three Baltic countries. Much of it has been prompted by requirements of the EU accession process – thus all three countries have implemented labour legislation that is in line with the EU in terms of regulations on working time, vacancies and termination of contract, non-discrimination rules and health and safety. However, as already been noted, the mechanisms for enforcing such legislation are sometimes lacking so the actual impact has been less than perhaps the letter of the law implies. However, limited enforcement contributes to *de facto* labour market ‘flexibility’.

Some initiatives have been created by pre-accession assistance programmes. For example in the sphere of social dialogue an important driver in the development of sectoral and regional social dialogue in Latvia has been the Phare-Twinning Project on the Promotion of Bipartite Social Dialogue. Apart from raising awareness of social dialogue the impact is difficult to assess – however the evidence suggests that the number of bilateral agreements is increasing. Also, there is now a proposal for tripartite social dialogue at the regional level.

All three countries have implemented pension reform with the introduction of funded pillars to supplement the former pay as you go systems. Here the initiative has been taken by the World Bank. The payoff to pension reform accrues over time but if the reform is credible there is an immediate impact on the incentive to participate in the official economy.

In the sphere of economic development there have been important policy changes in corporate taxation in Estonia and Latvia (not required by accession). Estonia introduced a zero rate of corporate income tax on reinvested profits and recently reduced the tax rate too. In Latvia there has been a dramatic reduction of corporate income tax by stages from 25% to just 15%. The aim is to follow the Irish model and attract FDI. A further move to reduce the tax rate to 12.5% has been put on hold following negative comment in the EU.

182. Estonia has made efforts to reform its business support system. In 2000 the Ministry of Economic Affairs and Communications reorganised the previous structure by establishing the Government foundation Enterprise Estonia (EAS). Enterprise Estonia is a merger of seven different organisations, including the former Innovation Foundation, the Tourist Board and Invest in Estonia. Compared to the earlier organisation, the new foundation has clear goals and an atmosphere of client friendliness. However, the results are disputed. The activities of the R&D Financing Programme of the EAS were evaluated by the State Audit Office in October 2004. One of the main gaps identified was that far fewer new jobs had been created than anticipated. The auditors remarked that EAS lacked routines for evaluating over-optimistic forecasts that had been presented by applicants, in addition they pointed out that the procedures were too slow and that there was no feed back to applicants about funding decisions.

183. In January 2002, Estonia followed Latvia in introducing an earnings related unemployment benefit. Employees (0.5% of wages) and employers (0.25% of the gross wages) pay insurance premiums into a special Unemployment Insurance Fund. This should guarantee the unemployed a higher level of welfare than before, which should increase mobility of employees in the labour market, providing them a possibility to look for a new job with less worry about their economic situation (Hinnosaar, 2003). The payment period is relatively short and should stimulate unemployed people to search for employment. In addition, in order to unify the administration of labour market measures, the Unemployment Insurance Fund, the Labour Market Board, the Ministry of Economic Affairs and Communications, the Ministry of Finance and the social partners aim at creating a new organisation model by 2005 (Estonia’s NAPE, 2004).

184. Estonia has made considerable efforts to adjust its labour market legislation and policy to requirements set by the International Labour Organisation (ILO) and the European Union. The impact on the labour market has been limited. The relatively high lay-off compensation and the time required to give notice of dismissal have so far been the only factors that have diminished the flexibility of the Estonian labour market. But the payment period and rate of unemployment benefits have been estimated to be low (Philips *et al*, 2002). Research indicates that considering all socio-demographic factors (age, health, place of residence, etc.), social transfers have not significantly influenced the probability of employment (Kuddo *et al*, 2002). However, both the unemployment insurance system that came into force in 2003 and the gradual increase in minimum wages (in 2002 32% of the average wages) are expected to diminish the flexibility of the labour market.

185. Lithuania has been especially active in reform of local government. In the first instance it totally reformed the system by removing the hundreds of small municipalities that prevail in both Estonia and Latvia. More recently it introduced a package of changes to local government that took effect with the local government elections of March 2000. There were changes in the borders of municipalities and an increase in their number, from 56 to 60. There was also a change in the term of office of local authorities from 3 years to 2 and a half years. The additional municipalities of Kalvarija, Kazlu Ruda, Pegege, Rietava & Elektrenai were created. At the same time Marijampole District was eliminated and its territory divided between Kalvarija and Kazlu Ruda. All of the new municipalities are small by Lithuanian standards. The largest is Elektrenai, with a population in 2003 of 29.000 compared to an average Lithuanian local authority population of 58.000.

186. In addition to the abolition of Marijampole District changes were made in the territory of 14 other previously existing municipalities (Birštonas, Druskininkai, Marijampole City, Vilnius City, Akmene, Kaisiadoriai, Lazdijai, Mazeikai, Plunge, Sakiai, Silute, Trakai, Varena and Vilkaviskis). For example, the inclusion of Grigiskes into the territory of Vilnius City was a result of lobbying by two members of parliament. Lobbying by another member to create a new municipality of Nemencine in Vilnius County failed, however. During the legislative process there were also calls to delay the changes until 2003.

187. As a result of these changes the population of Trakai was halved, from around 79 000 to 37 000, largely due to the creation of Elektrenai. Elektrenai also received territory from Kaisiadoriai. Two of the new municipalities were simply a part of one previously existing jurisdiction. Pegeges was previously contained within Silute. Rietavo was carved entirely out of Plunge. Hence both Silute and Plunge saw significant falls in their population, mitigated by the relatively small populations of the new municipalities.

188. Hence of the previously existing municipalities the most affected were Marijampole District, which was abolished and its territory divided between Kalvarija and Kazlu Ruda; and Trakai, which saw the half of its population around the town of Elektrenai separate into a new municipality. The impact of this reform can be seen in terms of the change in the municipal environment.

- *The division of Marijampole District into Kalvarija and Kazlu Ruda.* These two new municipalities are similar in terms of population and area, although a greater proportion of the residents of Kalvarija live in rural areas. Kalvarija's unemployment rate is 7-8 percent higher than that of Kazlu Ruda. Average recorded wages in Kazlu Ruda were 25 percent higher than in Kalvarija in 2000, but this difference had diminished to 8 percent by 2002. Kalvarija spends a higher proportion of its budget on social security and welfare.
- *The secession of Elektrenai from Trakai.* Elektrenai is less than half the area of the new Trakai District and hence has almost double the population density. Elektrenai's population live predominantly in urban areas whereas Trakai's population remains mostly rural. Trakai also has a greater proportion of ethnic minorities than Elektrenai; one third of Trakai's population are Poles.

Elektrenai's recorded wages were 12 percent higher than Trakai's in 2000, increasing to a 26% difference by 2002. Trakai's budget is shifted more towards expenditure on environment and utilities whereas Elektrenai spends proportionately more on recreation and culture.

- *Secession of Pageges from Silute.* Pageges is only a third of the size of the new Silute District, but is also less densely populated. Pageges is more heavily rural than Silute. However, the average wage in Pageges was 3 percent higher than in Silute in 2000 and this difference increased to 12 percent by 2002.
- *Secession of Rietavo from Plunge.* Rietavo is also smaller, less dense and more rural than its parent municipality. Rietavo's average wage was 9-10 percent higher than in Plunge.

189. Hence the main impact of this reform was to create new smaller municipalities. The division of Marijampole District created two jurisdictions with very different levels of unemployment, facilitating greater focus (including regional funds) on this problem in Kalvarija. Elektrenai's independence from Trakai allowed two areas with quite different demographics to align municipal spending more closely to the population's needs. More unusual was the creation of two small largely rural municipalities, Pageges and Rietavo. This may be an experiment that will prove useful, however, in evaluating proposals for more radical restructuring of Lithuanian local government.

5. CHALLENGES

As already outlined in section 1 all three Baltic countries have been growing exceptionally fast since the mid-1990s, so that living standards have risen in Estonia from 34% of the EU-25 average in 1995 to 49% in 2003, in Latvia from 30% to 41% over the same period, and in Lithuania from 34% to 46%. Employment has also improved especially in recent years. However, convergence of living standards remains a long way away and unemployment remains high with the LFS rate in all three Baltic countries above both the EU-15 rate and the EU-25 average rate, with only Poland and Slovakia posting higher unemployment. A major problem remains the persistence of large regional disparities on the basis of all indicators, especially in Latvia and Estonia.

Thus at a broad level the challenges facing the Baltics are:

- to maintain growth at rates that will achieve convergence of living standards with the rest of the EU
- to address regional disparities

Will stable currencies and prudent fiscal policies be sufficient to meet these challenges? One suspects not. All three countries surely have to continue with both deepening and broadening institutional reform in order to sustain growth and improve the quality of life of their inhabitants.

One key challenge and opportunity will be the deployment of the EU structural funds. All three countries are Objective 1 EU regions and hence will receive over 2004-2006, and almost certainly also over the next

programming period 2007-2013, quite large sums of money through the EU structural funds. These resources are of course very welcome but deploying them involves a number of risks (challenges). These include the following:

- The first challenge is simply that in general the funds should be used in ‘properly’ ie in good projects. Especially in the current programming period there has been a fear of poor take up and this has encouraged allocation procedures that favour fast take up rather than project quality.
- The risk of large-scale ‘rent seeking’ activity – for private enterprises the funds offer the possibility of ‘privately profitable’ projects and there is a danger that too many real resources will be used to compete for the capture of these profits.
- The risk that the funds will fail to address the regional disparity problem *within* the three Baltic countries. There are two problems here – one is simply that of perception and the other is more concrete. At the level of perception there is the problem that all three countries are small and hence in the EU regional policy nomenclature appear as NUTS II regions. This means that in EU wide descriptions of regional disparities the rather large disparities within all three countries simply do not appear. More concretely, the co-financing requirements of the structural funds mean that there is a risk that large and wealthy municipalities will appropriate a disproportionate share of SF resources.

This last point leads on to what is definitely a positive feature of the structural funds with respect to local economic development – namely that the structural funds will offer local authorities the opportunity to act as partners in both European Social Fund (ESF) and European Regional development Fund (ERDF) projects that can directly local employment and development issues.

At the same time, such opportunities point to a major challenge for both Estonia and Latvia. There is an urgent need, firstly, to accelerate and then complete their territorial reform in order to create local authorities that can operate at an effective scale. Research in Estonia by Oppi and Moora (2004) has shown that small and poor municipalities have been left behind in the allocation of pre-accession resources. They claim that their research “has demonstrated convincingly that mainly towns (instead of poorer rural municipalities), larger local government units (instead of more lagged-behind smaller ones), and those municipalities with higher level of socio-economic potential (instead of the more stagnant and vulnerable ones) have managed to obtain most of the resources available. It is serious threat for the post-accession structural policies, as well” (p 12). The same is surely also true for Latvia where there are also many hundreds of small and ineffective municipalities.

Other challenges for all three countries include the following:

- Increasing the level of ‘endogenous entrepreneurship’. According to the most basic measure of entrepreneurship – the number of SMEs per 1000 of population all three Baltic states lag far behind the EU-15, with even Estonia which is generally regarded as the most entrepreneurial of the three countries having a ratio that is less than half the EU-15 average. The Latvian and Lithuanian figure are still lower. Research undertaken at BICEPS⁶ for Latvia shows that using the Global Entrepreneurship Monitor (GEM) methodology the “new business prevalence index” for Latvia was (for 2003) 0.8 per 100 population. This compares with 3.2 for the UK, 4.9 for the USA, 3.1 for Finland, 2.1 for Sweden and 1.1 for Slovenia.

⁶ Unpublished discussion paper by Dombrovsky and Ubele (2005)

- Decreasing the ‘tax wedge’ on low incomes which is at about 40% in Latvia and Lithuania and about 37% in Estonia – this compares with an average of about 37% in both the EU-15 and the EU-25.
- The high tax wedge on low incomes is connected with another problem and hence challenge – the prevalence of undeclared work. Especially, in Latvia it is common practice to pay workers the minimum wage as delared income and to supplement this by undeclared cash payments ‘in the envelope’.
- The development of social dialogue. This is very weak at the bilateral level – in part because trade union coverage is very low, ranging from about 18% of employment in Latvia to 14% in Lithuania and 11% in Estonia. Coverage is especially low in the private sector. The development of meaningful social partnership at the local level is contingent on reasonably representative trade unions.
- The development of genuine local employment and economic development initiatives. All three countries remain highly centralised – especially because the central government holds most of the purse strings. Here the structural funds may provide the impetus for local development,
- Corruption, or the perception of corruption, remains a major problem and challenge – especially in Latvia and Lithuania.

5. CONCLUSIONS

This paper has attempted to examine the state of the governance of employment and economic development in the Baltic states. Several broad conclusions have emerged from this exercise:

- The governance of both employment and economic development remains highly centralised – not least because the central government holds most of the purse strings of local authorities. Only recently have there been serious attempts to develop a local more bottom-up approach. Often these attempts have been the result of collaboration with partners from abroad eg the local employment initiatives in Lithuania.
- The EU accession process has been crucial in shaping the institutions governing employment and economic development. Indeed, it is hard to imagine what the institutional environment would look like in the absence of the EU accession process. A notable example here is employment policy where the European Employment Strategy has provided a mandatory template for policy. This year, as member states, the three Baltic countries for the first time participated fully in the National Action Plan for Employment process.
- The EU is also important in terms of resources. Firstly with its pre-accession assistance – much of which in recent years has been aimed at improving institutional capacity, and from 2004 onwards,

with the structural funds which will provide opportunities for bottom-up local economic development.

- In Estonia and Latvia there is a clear and urgent need to accelerate territorial reform. In both countries the large number of small municipalities represent a barrier to the creation of effective local employment and economic development initiatives.

Finally, running through the governance structures is a tension between the old and the new – between the mentality of the Soviet Union and the vision of the EU. Thus in Estonia and Latvia the municipalities correspond to the old Soviet administrative units and are tenacious in their efforts to resist the territorial reform which will make more ‘modern’ employment and economic development practices more easy to implement effectively. At a broader societal level there is an absence of ‘trust’ which inhibits endogenous entrepreneurial development. Thus according to the results reported in Dombrovsky and Ubele (2005) more than 40% of new businesses in Latvia have just one owner, and another 25% have just two owners ie there is a ‘mistrust’ of majority rule.

What all of this confirms is what is intuitively clear – namely that it is a hard and time-consuming task to change a society, especially from outside. Social structures have a propensity to reproduce themselves. The Baltic states may have been acknowledged as ‘functioning market economies’ by the EU but it will be a long time (if ever) before they are indistinguishable from say a Scandinavian country such as Denmark or Sweden.

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